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# THE ETHICS AND THE ECONOMICS OF TORT LIABILITY INSURANCE

Gary T. Schwartz†

## I

### INTRODUCTION

Very frequently a liability insurance policy intervenes between a court's tort judgment and the actual tort defendant. The significance of this intervention is potentially great. Tort law often is justified as achieving fairness in the allocation of losses.<sup>1</sup> Yet often it is claimed that liability insurance, by removing liability from the shoulders of the actual tortfeasor, frustrates tort law's fairness goals.<sup>2</sup> In addition, tort law is commonly commended as a deterrence measure.<sup>3</sup> Yet insurance, by removing from the defendant the threat of actual liability, obviously calls into question tort law's ability to achieve deterrence. Indeed, many scholars share in the view that tort law's deterrence objective is "severely, perhaps fatally undermined" by the prevalence of insurance.<sup>4</sup>

This Article consists of my effort to work out the relationship between liability insurance and tort law's fairness and deterrence

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† Professor, UCLA School of Law. This Article has profited from presentations at faculty workshops at UCLA, USC, NYU, Stanford, and Boalt Hall. Special thanks to Richard Craswell, Richard Epstein, Lewis Kornhauser, Mitch Polinsky, Hugh Scogen, Ken Simons, and Matthew Spitzer.

<sup>1</sup> See, e.g., James A. Henderson, Jr., *The New Zealand Accident Compensation Reform* (Book Review), 48 U. CHI. L. REV. 781, 791, 794, 797-98 (1981).

<sup>2</sup> See, e.g., P.S. Atiyah, *No Fault Compensation: A Question that Will Not Go Away*, 54 TUL. L. REV. 271, 288 (1980); Peter Cane, *Justice and Justifications for Tort Liability*, 2 OXFORD J. LEG. STUD. 30, 44-46 (1982); Joseph Ferreira, Jr., *Promoting Safety through Insurance*, in SOCIAL REGULATION: STRATEGIES OR REFORM 267, 269 (Eugene Bardach & Robert A. Kagan eds. 1982); Stanley Ingber, *Rethinking Intangible Injuries: A Focus on Remedy*, 73 CALIF. L. REV. 772, 790-93 (1985); Stephen B. Sugarman, *Doing Away With Tort Law*, 73 CALIF. L. REV. 558, 603 (1985); Alan O. Sykes, Book Review, 56 U. CHI. L. REV. 1153, 1155 (1989); Paul Weiler, *Legal Policy for Medical Injuries* 89 (June 1987) (unpublished manuscript available from the Cornell Law Review).

<sup>3</sup> See, e.g., WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* (1987); STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* (1987).

<sup>4</sup> John G. Fleming, *The Role of Negligence in Modern Tort Law*, 53 VA. L. REV. 815, 823 (1967); see also GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 239, 248 (1970); GEOFFREY PALMER, *COMPENSATION FOR INCAPACITY* 24 (1979); Richard L. Abel, *Torts*, in *THE POLITICS OF LAW: A PROGRESSIVE CRITIQUE* 185, 191 (David Kairys ed. 1982); Izhak England, *The System Builders: A Critical Appraisal of Modern American Tort Theory*, 9 J. LEGAL STUD. 27, 55 (1980); Richard J. Pierce, Jr., *Encouraging Safety: The Limits of Tort Law and Government Regulation*, 33 VAND. L. REV. 1281, 1298-1300 (1980); Glanville Williams, *The Aims of the Law of Tort*, 4 CURRENT LEG. PROBS. 137, 165-68 (1951). But see Fleming, *supra*, at 825.

objectives. Of course, if insurance does frustrate those objectives, one response would be for courts to refuse to recognize the validity of liability insurance contracts.<sup>5</sup> Tort liability insurance seems not to have existed in this country prior to 1886.<sup>6</sup> During succeeding years, however, as tort liability itself became increasingly common, companies began offering negligence insurance policies. A short series of judicial opinions proceeded to address the question of whether the common law should give effect to these insurance contracts. The finale of this series—the Missouri Supreme Court's divided opinion in *Breeden v. Frankford Marine Plate Accident & Glass Insurance Company*<sup>7</sup>—now serves as a standard citation for the conclusion that negligence liability insurance policies are legally proper.<sup>8</sup> By now, most of us take the *Breeden* result utterly for granted; yet at the same time many of us persevere in complaining that liability insurance is inconsistent with tort law's fundamental objectives. Acknowledging this tension, this Article will consider whether *Breeden* was indeed correctly decided; as the Article's analysis unfolds, the positions taken by the *Breeden* majority and dissent will be set forth in the margins. To the extent that this analysis confirms that liability insurance is acceptable, the Article will explore the implications of this result.

In maintaining its focus on liability insurance, this Article will largely adhere to a policy of open-mindedness or agnosticism as to the actual objectives of tort law. That is, the Article will not profess to determine whether the best justification for tort rules comes from principles of fairness, from expectations of deterrence, or from

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<sup>5</sup> "At the beginning of the nineteenth century, liability insurance would have been unthinkable. It would have been considered . . . immoral . . ." 11 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW, TORTS 1-90 (André Tunc ed. 1983). See generally Mary Coate McNeely, *Illegality as a Factor in Liability Insurance*, 41 COLUM. L. REV. 26 (1941). Liability insurance is not tolerated in the Soviet Union, on grounds that it both frustrates tort law's fairness goals and undermines its deterrence capacity. See Alice Erh-Soon Tay, *The Foundation of Tort Liability in a Socialist Legal System: Fault Versus Social Insurance in Soviet Law*, 19 U. TORONTO L.J. 1, 15 (1969).

<sup>6</sup> An employer's liability policy in 1886 was the first liability insurance in America. See C. ARTHUR WILLIAMS, JR., *INSURANCE ARRANGEMENTS UNDER WORKMEN'S COMPENSATION* 3-4 (1969). See also the chronology of policies set forth in C.A. KULP & JOHN W. HALL, *CASUALTY INSURANCE* 20-22 (4th ed. 1969).

<sup>7</sup> 220 Mo. 327, 119 S.W. 576 (1909). The court divided 5-2 on this issue. In a sense, however, all seven votes were dictum, as the court was unanimous on another issue that disposed of the appeal. For the sake of convenience, this Article will refer to the block of five judges as the "majority" and the block of two as the "dissent."

<sup>8</sup> See, e.g., ROBERT E. KEETON, *INSURANCE LAW: BASIC TEXT* 287 n.7 (1971).

American courts are currently divided as to the acceptability of liability insurance for punitive damages. See George L. Priest, *Insurability and Punitive Damages*, 40 ALA. L. REV. 1009 (1989). For a brief discussion of the punitive damage issue, see Gary T. Schwartz, *Deterrence and Punishment in the Common Law of Punitive Damages: A Comment*, 56 S. CAL. L. REV. 133, 136-37 (1982).

some combination of both. Within the fairness-oriented literature, there are lively disputes as to which fairness argument makes the most sense. No effort will be made here to arbitrate those disputes; likewise, the Article will not profess to ascertain which particular deterrence analysis is the most persuasive. Rather, in adhering to its open-minded plan, the Article will tend to accept as a given as many of these arguments as possible, and will then evaluate the relationship of each of them to the institution of liability insurance. In addition, after taking fairness and deterrence into account, the Article will give consideration to the idea that compensating victims through loss spreading is the social policy that tort law may be trying to achieve; at this point the Article will assess how this possible tort objective fits in with liability insurance.

The Article's conclusions can be briefly summarized. Liability insurance is quite consistent with certain fairness rationales that often are attributed to tort law—but quite inconsistent with others. Liability insurance plays an essential role if loss spreading is a proper tort objective; that it is such an objective is, however, subject to considerable doubt. As far as deterrence is concerned, the economists are wrong: it cannot be concluded that liability insurance is a priori efficient. Rather, the efficiency of many forms of liability insurance depends on the balance to be struck among several factors that the Article identifies. Because these factors, at least for the time being, do not lend themselves to empirical evaluation, the efficiency of much of liability insurance is currently indeterminate. Given the significance of liability insurance within the tort system, this is a guarded assessment that casts doubt on the idea that this system rests on a solid economic foundation. Indeed, my own personal (and non-agnostic) view, set forth at the very end of the Article, is that liability insurance can be most clearly justified if tort law is appreciated in ethical rather than merely economic terms.

## II

### FORMS OF INSURANCE

Even if liability insurance is regarded as posing a serious problem for tort law, an obvious point is that this insurance is by no means comprehensive among tort defendants.<sup>9</sup> Many defendants are almost wholly without insurance: *i.e.*, they are “self-insured” (an odd euphemism for “uninsured”)<sup>10</sup> or they “go bare” (a phrase that emphasizes the vulnerability of dispensing with insurance). As of

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<sup>9</sup> “Defendant” is used in this Article to refer not only to parties being sued in tort but also to parties who engage or might engage in dangerous conduct that might give rise to eventual tort suits.

<sup>10</sup> Self-insurance often signifies that an entity has set up an insurance-like program

1986, the Ford Motor Company had "little or no" liability insurance coverage.<sup>11</sup> By 1988, the City of New York was wholly self-insured;<sup>12</sup> apart from a limited number of specialized policies, so were the City of Los Angeles,<sup>13</sup> the County of Los Angeles,<sup>14</sup> and the State of California.<sup>15</sup>

Furthermore, even when parties do purchase liability insurance, the policies often contain features that provide for significant elements of self-insurance. Almost every liability insurance policy written in this country has some cap or policy limits;<sup>16</sup> above this cap the defendant is without insurance.<sup>17</sup> Some insurance policies have a deductible below which the defendant is not covered by insurance.<sup>18</sup>

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for reserving funds and handling claims. Some entities, although self-insuring for liability, hire an insurance company to manage the process of claims administration.

<sup>11</sup> See *Ford Tells SEC of Billions in Possible Product Liabilities*, L.A. Times, May 10, 1986, § 6, at 1, col. 1. George Priest estimates that by 1986 at least 60% of all products liability pay-outs were financed by self-insurance. George L. Priest, *The Antitrust Suits and the Public Understanding of Insurance*, 63 TUL. L. REV. 999, 1009 (1989).

<sup>12</sup> See Patricia Bellew Gray, *City's Nemesis*, Wall St. J., Mar. 16, 1988, at 1, col. 1.

<sup>13</sup> Telephone interview with Art Cupple, Risk Manager, City of Los Angeles (June 23, 1989). The purchase of liability insurance is sometimes required by the terms of bond issues.

<sup>14</sup> Telephone interview with Linda Felix, Risk Management Officer, County of Los Angeles (July 3, 1989).

<sup>15</sup> Telephone interview with Richard Beck, Office of Insurance and Risk Management (August 3, 1989).

The larger the number of risky episodes in which the entity engages, the more those risks will tend to average out within the entity itself, hence rendering less necessary the risk-pooling effects of liability insurance. It is not surprising, then, that larger organizations have a disproportionate tendency to self-insure.

<sup>16</sup> The information on actual insurance practices in this and later paragraphs has been derived from telephone conversations with many insurance agents and brokers.

<sup>17</sup> The majority opinion in *Breedon*, apparently thinking of policy limits, emphasized that "the indemnity provided by liability insurance is only limited and partial." 220 Mo. at 430, 119 S.W. at 608. The dissent, however, thought that it was "self-evident" that "if the indemnity is only partial, then to that extent the responsibility and the corresponding degree of care required to be exercised are reduced to the extent of the indemnity, whether partial or complete." *Id.* at 357, 119 S.W. at 583. Whether policy limits make sense, in economic terms, as a way of encouraging care on the part of an insured is an uncertain question. On the oddity of policy limits in first-party health insurance, see Mark V. Pauly, *Taxation, Health Insurance, and Market Failure in the Medical Economy*, 24 J. ECON. LIT. 629, 642 (1986).

A common feature of health insurance is a continuing division of cost pursuant to a preestablished formula (often 80%-20%). Such formulary divisions are rare in liability insurance contracts. It is easy enough to understand why. Such an arrangement would implicate the financial interests of both the insurer and the insured in the administration of every dollar of every tort claim. Accordingly, there would be troublesome problems of coordination and the resolution of possible conflicts.

<sup>18</sup> This deductible can be written on either a per-occurrence or per-annum basis. Likewise, policy limits, as described above, can be defined in an occurrence or an annual-aggregate way.

Deductibles are less attractive in liability insurance than they are in first-party insurance, such as health insurance. A first-party insurance deductible eliminates many claims altogether, as well as the cost of processing those claims. By contrast, a liability

Other defendants, though generally self-insured, secure the protection of an "excess" or "catastrophic" liability policy that takes effect once losses go above some certain point. Analytically, of course, a deductible is equivalent to an excess arrangement; pursuant to each, the defendant is insured only once liability reaches some predetermined level. Yet as a matter of the common language surrounding insurance practices, there is a major difference between the two: people refer to deductibles when the predetermined level is quite low, to excess coverage when this level seems high. Variations on themes such as these can be seen in the practice of "retrospective rating."<sup>19</sup> Under retrospective rating, the insured pays a premium at the beginning of the policy year. At the end of the year, the insured's actual liability record is toted up, and the insured is then either given a rebate or assessed a surcharge to take that actual record into account; however, these rebates and surcharges may not exceed certain predetermined amounts. In essence, retrospective insurance is an arrangement pursuant to which the insured is in fact bare over some substantial range of liability possibilities.<sup>20</sup>

For defendants like Ford and New York City who are wholly or almost wholly without insurance, there clearly is nothing in the practice of liability insurance that interferes with the achievement of whatever tort law's goals might be. Inasmuch as such parties are defendants in a significant proportion of all tort cases, their self-insurance defeats the broadest statements as to how liability insurance undermines those goals. Even so, insofar as judicial opinions such as *Breedon* give expression to judicial understandings as to what tort law is all about, the issues raised by liability insurance cannot be entirely ignored even when thinking about the tort liability of these parties. As for defendants who are partially self-insured, to observe that they have this status is to acknowledge that they are partially covered by insurance policies; hence the acceptability of insurance is an issue of obvious relevance.

As this Article worries about the practice of liability insurance, it will assume that parties are in a position to purchase insurance for the discrete activities that they engage in. Though there are certain

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insurance deductible merely diverts a claim from the insurer to the insured, who may be, moreover, in a poorer position to process it. Moreover, if the plaintiff's total loss exceeds the deductible, the deductible serves to divide the claim between insurer and insured, leading to a costly problem of coordination.

<sup>19</sup> See C. ARTHUR WILLIAMS, JR., *supra* note 6, at 79-82.

<sup>20</sup> The insured pays, however, a necessary premium (the original premium minus the maximum rebate) to secure coverage above some necessary level (the original premium plus the maximum surcharge). Whether this level is moderately high or "catastrophically" high depends on which of several available retrospective plans the insured has chosen.

problems with this concept of "activity,"<sup>21</sup> for most purposes it works well enough. In light of the concept, an individual who is a doctor might well have three liability insurance policies: one that covers him in his role as motorist, another in his role as homeowner,<sup>22</sup> and a third in his role as a medical professional.<sup>23</sup> For any particular person, the actual extent of tort liability is a consequence of roughly five factors: the range of activities that the person chooses to engage in, each of which has its own risky character; the quantity (and quality) of the actual risks that the person generates as he pursues that activity;<sup>24</sup> the operation of the factor of chance, which determines which of these risks in fact materialize in injuries; the factor of chance again, insofar as it establishes the seriousness of those injuries; and finally, the vagaries of the litigation process, inasmuch as they determine which injuries actually result in which legal liabilities.

In conceiving of insurance within an activity framework, this Article will primarily consider two polar forms of insurance.<sup>25</sup> One is insurance that is "completely flat": insurance whose premiums and other terms takes no account of the level of risks created by an insured as he pursues a particular activity. Completely flat insurance, while unusual, is not unknown in the real world. For example, many

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<sup>21</sup> In reviewing insurance practices generally, a key point to appreciate is that an insurance company will continue to develop narrower categories until the point is reached at which the costs incurred in further subcategorization catch up with the competitive benefits that the company gains by that subcategorization. This balance between costs and benefits determines the extent to which insurance premiums are responsive to an insured's actual risktaking (as will be described below). That balance also explains how broadly or narrowly insurers define the "activities" that they take into account. In addition, the balance governs the extent to which insurers worry about the "level" at which the insured engages in an activity. As far as activity levels are concerned, malpractice insurance ignores the number of surgeries a doctor performs and the number of hours he works. By contrast, the premiums for products liability insurance are calculated as a predetermined percentage of dollars of sales. Such a formula renders the premium a direct function of the number of products sold. Auto insurers make an effort to ascertain the length of the insured's commute to work (a simple fact that is constant in the short run), but they generally do not inquire into the insured's actual annual mileage. The control of a defendant's "activity level" is an important theme in modern strict liability theory. See *infra* text accompanying note III.

<sup>22</sup> In fact, the liability portions of some homeowners policies provide general liability protection, excluding only liabilities that arise from business activities or motor vehicle use. In one recent situation, a wrongful-death judgment entered against a deerhunter who negligently shot a local resident was covered by the hunter's homeowners insurance policy. See James Howard Kunstler, *A Killing in Maine*, N.Y. Times, Sept. 10, 1989, § 6 (magazine), at 58, col. 1.

<sup>23</sup> In practice, insurers charge doctors by taking their specialization into account. See *supra* note 21.

<sup>24</sup> If the defendant is operating under a rule of strict liability, all that may matter is the quantity of his risks. If something like negligence is the liability rule, then the quality of risks matters greatly as well.

<sup>25</sup> In this regard, this Article follows the lead of S. SHAVELL, *supra* note 3, at 195-96.

lines of "personal" insurance—including homeowners liability insurance and professional malpractice insurance—make no effort to reflect the individual's accident potential.<sup>26</sup> A further example of completely flat insurance can be found in Australia today, where auto insurance for personal injury liability relies on a flat rate that ignores almost all variables concerning the individual insured; no matter how frequently a motorist is involved in drunk driving accidents, his premium remains the same.<sup>27</sup>

The usual explanation for flat insurance practices relates to the difficulties insurance companies face in acquiring, in a reasonable-cost way, the information needed for the calculation of risk-responsive premiums. Homeowners' insurers *could* inspect residential premises and evaluate the liability risks occasioned by particular insureds; but insurance companies evidently have concluded that the cost of such an inspection program would exceed the limited value of the information that this program would uncover. Insurers *could* take into account, in fixing premiums, the past claims records of professionals who apply for new insurance; evidently, however, the number of past claims tends to be so low as to deprive these claims records of predictive credibility.<sup>28</sup> Of course, even an insurance company that declines to adopt a sophisticated premium schedule will, if confronted by a sufficiently high-risk insured, at some point take this into account: for example, the company might decline to renew the policy of a homeowner who has three dog-bite claims outstanding against him. In light of options such as this, within private insurance markets completely flat insurance stands as a very extreme case. An extreme result is obtained in Australia—but this is only because all auto insurance is there written by a single governmental insurer, which, as a matter of politics or public policy, has historically chosen to adopt a practice of premium uniformity which overrides the classifications that the economics of private insurance would otherwise suggest.<sup>29</sup>

The second form of insurance to be discussed in this Article is

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<sup>26</sup> The time that the doctor spends assisting the insurance carrier in preparing a defense to a malpractice claim serves, perhaps, as an in-kind deductible. Moreover, in medical malpractice insurance there have been very recent moves in the direction of formal experience rating. See Patricia M. Danzon, *Medical Malpractice Liability*, in *LIABILITY: PERSPECTIVES AND POLICY* 101, 119 & n.39 (Robert E. Litan & Clifford Winston 1988).

<sup>27</sup> See Gary T. Schwartz, *The Advantages of Tort*, in *PERSONAL COMPENSATION FOR INJURY* 70, 74-75 (Australia Attorney-General's Department ed. 1984). The drunk driver may, of course, at some point lose his driver's license.

<sup>28</sup> That those claims often relate back to doctor behavior which took place several years previous likewise diminishes their predictive power. For a general discussion of experience rating in malpractice insurance, see P. Weiler, *supra* note 2, at 110-15.

<sup>29</sup> See Schwartz, *supra* note 27.



insurance that is "perfectly responsive": insurance whose premiums are set so as to exactly relate to the level of risk that the insured's own conduct occasions. There are two possible objections to the norm of perfectly responsive insurance. First, because this insurance fails to pool insureds who have different risky characteristics, some might appraise it as not really partaking of the insurance function. This appraisal would, however, be wrong. Responsive insurance remains insurance in a strong sense: while it takes full account of the insured's actual risk level, it nevertheless fully protects the insured against the vicissitudes of pure chance, inasmuch as it is chance that converts original risks into actual injuries with specific severities. Secondly, the very concept of perfectly responsive insurance might strike many readers as unreal or bizarre, insofar as the concept conjures up an image of an insurance company constantly "observing" the behavior of the insured and then continuously adjusting the insurance premium.<sup>30</sup> Certainly, on account of the costs referred to above, no such process of observations and premium adjustments takes place in the real world.<sup>31</sup> Nevertheless, there are major elements of responsiveness in many insurance arrangements. Under "schedule rating,"<sup>32</sup> the insurance company adjusts the premium charged to an insured by taking into account the information yielded by an inspection or survey of the insured's operations. Schedule rating is a common feature in products liability insurance, commercial landowner-and-occupiers' insurance, auto-fleet insurance, and aviation insurance. Under "merit rating" and "experience rating," the insurance company sets its premiums by taking into account the recent liability record of the insured, on the theory, identified above, that the insured's previous torts have some validity in predicting the future.<sup>33</sup> Experience rating<sup>34</sup> is a commonplace in

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<sup>30</sup> See Steven Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120, 127-28 (1982).

<sup>31</sup> The possibility of observation and monitoring also comes up in the discussion of vicarious liability rules such as respondeat superior. Here the notion of observation does seem meaningful, as the employer often is in a good position to observe the continuing behavior of his employee.

<sup>32</sup> Professor Abraham calls this "feature rating." KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 71-73 (1986).

<sup>33</sup> Sometimes it is suggested, as an alternative to this explanation, that experience rating is a practice that insurers engage in so as to encourage the insured to behave nontortiously during the course of the current insurance contract (that is, so as to reduce moral hazard). Insurers, however, generally refuse to engage in experience rating when the information about past claims does not seem rich enough to give it predictive power. This refusal confirms the prediction explanation for experience rating and seems to reject the alternative moral-hazard explanation.

<sup>34</sup> Extremely interesting results can be produced by certain combinations of partial self-insurance and risk-responsive insurance pricing. Consider the institutional defendant that is protected only by a catastrophic policy. If, in Year X, an accident occurs that is below the catastrophic level, the defendant pays for its liability in full. Yet the catastrophic insurer which engages in experience rating may inquire about the incident and

personal auto insurance, workers' compensation insurance, and hospital insurance, as well as in the other lines of insurance listed just above.<sup>35</sup>

In considering the combination of schedule rating and experience rating, one obvious observation is that they merely move liability insurance in a responsive direction. Perfectly responsive insurance, like completely flat insurance, remains an idealization. Almost all insurance policies lie in the vast intermediate range between the two. Even so, the two extreme forms of insurance may be quite useful as "ideal types" in the evaluation of the impact of insurance on tort law's basic objectives. That is, once the impact of these ideal types of insurance is ascertained, it should become possible to derive evaluations of insurance in its more typical intermediate forms. This Article indeed relies on such an ideal-type strategy whenever it refers to insurance that is "primarily" flat or insurance "to the extent that" it is responsive.<sup>36</sup>

### III

#### THE FAIRNESS OF LIABILITY INSURANCE

Certain introductory observations can be ventured as to the logic of liability insurance. By virtue of the law of large numbers, an insurer, by writing a sufficient number of policies, can all but eliminate most of the risks that the threat of liability entails when that threat is originally borne by private parties.<sup>37</sup> Those parties, with-

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then take it into account by raising the defendant's premium for Year  $X + 1$ . Thus the partially insured defendant can easily end up paying more than 100 percent of the liability cost of a particular occurrence. For discussion of phenomena such as these in workers' compensation insurance, see RICHARD B. VICTOR, *WORKERS' COMPENSATION AND WORKPLACE SAFETY: THE NATURE OF EMPLOYER FINANCIAL INCENTIVES* (1982).

<sup>35</sup> One point worth noting about experience rating is that its immediate focus is on the insured's past liability record rather than on his current degree of riskiness. To this extent, experience rating is responsive to actual liability rather than to risktaking as such. To be sure, this point should not be overstated; insurers take past liability into account only because it seems predictive of current liability potential. Nevertheless, the attention that experience rating pays to actual liability renders it, for certain purposes, a quite distinctive form of responsive insurance; for example, experience rating bears a resemblance to partial self-insurance, since under each arrangement a portion of the cost of actual liability ends up being borne by the insured.

Obviously, insurance arrangements in which the price of insurance is perfectly responsive to the insured's actual liability would provide no insurance protection at all. In this way, the norm of insurance that is perfectly responsive to risktaking is much more coherent than the norm of insurance that is perfectly responsive to actual liability.

<sup>36</sup> However, at least at two junctures, the strategy does not suffice—inasmuch as insurance in the intermediate range turns out to exhibit characteristics that are not displayed by insurance at either extreme. When these junctures are reached, the Article will depart from its general strategy in order specifically to discuss those liability policies whose character is realistically intermediate. See *infra* text accompanying notes 102, 187.

<sup>37</sup> See George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 *YALE L.J.*

out insurance, are faced with the risk of being subjected to a tort liability judgment that might be devastating or at least disruptive. To the extent that these parties are averse to this risk, their purchase of an insurance policy is an intelligent step. Economists generally believe that the risk aversion implicit in an insurance policy is a relatively simple matter—an easy deduction from the doctrine of the diminishing marginal utility of money.<sup>38</sup> My own view is that the risk aversion that leads to liability insurance is a difficult rather than an easy phenomenon. Here I can refer to recent psychological studies that have highlighted the curiosities and complexities of human conduct in the face of various kinds of risks;<sup>39</sup> also noteworthy is that the risk aversion commonly associated with human beings is difficult to attribute to publicly held corporations.<sup>40</sup> This Article will not endeavor to explore these complications; for present purposes, it is enough to say that if a person or firm is for any reason averse to the risk of a substantial tort liability, that party may find it advantageous to acquire an insurance policy.<sup>41</sup>

Assume, then, that an applicant and an insurance company voluntarily choose to enter into an insurance contract. What follows from the fact of this mutual choice? For one thing, the welfare of each party, as perceived by each, is evidently enhanced by the insur-

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1521, 1540 (1987) (emphasizing that the risks covered by insurance should be uncorrelated); *infra* note 123.

The *Breeden* majority strongly stated the benefits of spreading losses through liability insurance: "[T]he diffusion of losses arising from indemnity insurance against negligence . . . promotes business [and] tends to make it stable . . ." 220 Mo. at 430, 119 S.W. at 608.

<sup>38</sup> See KENNETH J. ARROW, *ESSAYS IN THE THEORY OF RISK-BEARING* 200 (1970); J. Hirschleifer & John G. Riley, *The Analytics of Uncertainty and Information—An Expository Survey*, 17 J. ECON. LIT. 1375, 1382 (1979).

<sup>39</sup> The studies suggest that people tend to prefer a guaranteed moderate gain to the possibility of a larger gain. To this extent people seem risk-averse. See Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOLOGIST 341, 342 (1984). But people also tend to prefer the possibility of a larger loss to the certainty of a smaller loss. In this insurance-related setting, they behave in a risk-preferring manner. See *id.* at 342-43. An additional point, though, is that people tend to regard the bearing of a "cost" as less unpleasant than the suffering of a "loss." See *id.* at 348-49. Liability insurance hence may serve the helpful psychological function of converting possible "losses" into more acceptable "costs."

<sup>40</sup> See Gary T. Schwartz, *Directions in Contemporary Products Liability Scholarship*, 14 J. LEGAL STUD. 763, 775 (1985). David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281 (1982), offer several explanations for that demand that build on the assumption of the corporation's pursuit of its own self-interest. Further explanations might focus on the personal interests of those corporate managers who actually make the decision to buy liability insurance on behalf of the company; they might be seeking, for example, to avoid any severe corporate setbacks that might threaten their own job security.

<sup>41</sup> More fully stated, it makes sense to buy insurance if the advantage in risk reduction exceeds the administrative cost or "load" of the insurance policy itself. This load is often estimated at 25% of the premium.

ance arrangement; accordingly, at least on first impression, the enforceability of that policy is economically advantageous. At the same time, the goals of ethics are generally advanced if individuals are allowed, in a voluntary way, to enter into contracts that they know will be binding on them;<sup>42</sup> there is thus an ethics of contractual choice that corresponds to the efficiency of contractual choice. Under an easy first iteration, then, the insurance contract is desirable ethically as well as economically.<sup>43</sup>

There is, moreover, a more specific form of ethical appeal in a contract that provides insurance protection against the prospect of tort liability.<sup>44</sup> Consider several persons, each of whom engage in risky conduct that essentially is similar; assume further, that because of the fortuities of chance, one and only one of them will end up being subjected to a devastating tort liability.<sup>45</sup> In light of the equality in their basic conduct, the fortuitous designation of one person as a liability-bearer seems unfair—a violation of the principle of horizontal equity.<sup>46</sup> To be sure, the immediate explanation for this individualization of liability is that the conduct of one person alone has turned out to be the “cause” of the plaintiff’s serious injury. But so long as this individualization of causation is merely a matter of chance or luck<sup>47</sup>—and so long as the person gains no actual advantage from the fact that his is the risk that turns out to result in

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<sup>42</sup> See CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 13 (1981).

<sup>43</sup> Indeed, many courts have justified new tort liability rules by emphasizing that the availability of insurance enables defendants to protect themselves against the chance of disruptive liability. See, e.g., *Haynes v. Presbyterian Hospital Ass’n*, 241 Iowa 1269, 1273, 45 N.W.2d 151, 154 (1950) (abrogating charitable immunity); *Hicks v. State*, 88 N.M. 588, 590, 544 P.2d 1153, 1155 (1975) (abrogating governmental immunity), *superseded by statute as stated in* *Cole v. Las Cruces*, 99 N.M. 302, 657 P.2d 629 (1983).

<sup>44</sup> According to Glanville Williams and his co-author, the fairness appeal of liability insurance lies in its ability to protect a tortfeasor from liability that is “out of proportion” to the degree of fault; absent liability insurance, a defendant who is only slightly at fault can nevertheless be subjected to a huge liability. See GLANVILLE WILLIAMS & B.A. HEPPLER, *FOUNDATIONS OF THE LAW OF TORT* 124-25 (1976). This proportionality rationale for liability insurance seems underinclusive. After all, the insurer pays the claim even when the defendant’s negligence is substantial and even when the plaintiff’s injury is no more than moderate. Perhaps, however, Williams’ background point is that liability insurance is fair because it protects a defendant against the fortuities of accident severity. So interpreted, his argument is consistent with the analysis that follows in the text.

<sup>45</sup> Actually, two fortuities are conflated here. The first: many parties are negligent, but only a few injuries result. The second: of these few injuries, only one is serious. Under my analysis, liability insurance protects against each form of fortuity.

<sup>46</sup> See John Martin Fischer & Robert H. Ennis, *Causation and Liability*, 15 PHIL. & PUB. AFF. 33 (1986) (discussing hypothetical described *infra* in text accompanying note 91); see also Sugarman, *supra* note 2, at 573 n.67.

<sup>47</sup> One recent philosophical treatment of the morality of luck is Michael J. Zimmerman, *Luck and Moral Responsibility*, 91 ETHICS 374 (1987).

injury<sup>48</sup>—it is hardly clear that the factor of causation justifies what would otherwise be a horizontal-equity violation.<sup>49</sup> In any event, whether or not the imposition of full liability (on the basis of fortuitous causation) is itself unfair, the law clearly promotes fairness when it at least permits each of these individuals to protect himself against chance by purchasing liability insurance.<sup>50</sup>

To be sure, the exact strength of this fairness claim may be dependent on several variables. One is the nature of the insurance policy. The hypothetical above, with its emphasis on the similarity in the conduct of the several parties, is most effective when insurance is perfectly responsive, so that parties who engage in equal risktaking end up paying equal premiums. Flatly priced insurance certainly protects parties against the ravages of risk and bad luck—and from an ethical perspective this is no mean accomplishment. Still, it does so in a way that lumps together parties with very different risktaking characteristics; and this somewhat diminishes its fairness appeal.<sup>51</sup> The precise rule of liability that courts are applying also affects the overall power of the fairness idea. If negligence is the rule, then a party can avoid subjecting himself to the fortuities of chance by adopting the seemingly straightforward strategy of avoiding negligent conduct.<sup>52</sup> However, when liability is based, as it frequently is, on strict liability principles,<sup>53</sup> this strategy is not

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<sup>48</sup> On this factor, see Jules L. Coleman, *Moral Theories of Torts: Their Scope and Limits: Part II*, 2 LAW & PHIL. 5, 7 (1983).

<sup>49</sup> For further discussion on whether it is proper to regard causation as mere fortuity, see *infra* text accompanying note 96.

Implicated here is a much-discussed question within the criminal law: should "attempts" be punished less severely than completed crimes? For one analysis, see Michael Davis, *Why Attempts Deserve Less Punishment than Complete Crimes*, 5 LAW & PHIL. 1 (1986).

<sup>50</sup> This same point has recently been made in Richard A. Epstein, *Luck*, 6 SOC. PHIL. & POL. 17, 29-30 (1988).

<sup>51</sup> Indeed, given this feature, completely flat insurance runs the risk of creating a distinct form of unfairness. Under a flat regime, insurance is offered at an equal price to parties who may be significantly unequal in the risks they create. By treating unlike persons alike, flat insurance apparently departs from the norm of horizontal equity. To be sure, the low-risk person can avoid the unfairness of an average-risk premium by declining to purchase an insurance policy. This ability to turn down insurance provides a powerful response to any claim that flatly priced insurance is unfair. Although this is a powerful response, in many circumstances it may not be powerful enough. If the individual, for whatever reason, is strongly averse to the risk of liability, then the nonpurchase of insurance may not be a realistic choice. Moreover, when the law requires the individual to purchase insurance, then this is not even a legally permissible choice.

On the general topic of the fairness of systems of risk classification adopted by liability insurers, see K. ABRAHAM, *supra* note 32, at 64-100; GUIDO CALABRESI, *IDEALS, BELIEFS, ATTITUDES AND THE LAW* 35-44 (1985).

<sup>52</sup> On the actual complexities of this strategy, see *infra* text accompanying notes 151-54.

<sup>53</sup> Frequently it is said that in contemporary tort law negligence liability is the general rule, strict liability the exceptional situation. See, e.g., Saul Levmore, *Rethinking Comparative Law: Variety and Uniformity in Ancient and Modern Tort Law*, 61 TUL. L. REV. 235,

available: the party may not have any reasonable-cost way of avoiding the conduct that gives rise to liability. Under these strict-liability circumstances, the fairness features of liability insurance become especially prominent.

Moreover, one premise of the previous paragraph—that under a negligence rule a party can escape liability by simply avoiding negligent conduct—deserves to be called into question. Most observers of our existing tort system agree that it includes a very considerable capacity for error: even if a defendant's behavior is nonnegligent in fact, there is a significant chance that a jury will err and hold him liable. Of course, this language of "error" assumes that there is a *right* answer that the jury proceeds to get *wrong*. A separate problem of "uncertainty" suggests that there frequently is no right answer at all—in light of the vagueness that characterizes core tort concepts such as "negligence." As a result of this uncertainty, even if the defendant and the jury are *both* conscientious *and* competent, the defendant cannot, by merely endeavoring to behave reasonably, eliminate the chance that his actual conduct will eventually be found faulty by the jury.

Accordingly, one of the "risks" that a defendant protects himself from by purchasing liability insurance is the risk that conduct which he intelligently believes is nontortious will nevertheless be designated as tortious by eventual juries, as a result of either error or uncertainty.<sup>54</sup> Yet to identify this risk is to suggest another fairness advantage in liability insurance. From a fairness perspective, it certainly is deeply unfortunate that the current tort system so frequently exposes a defendant to false or doubtful findings of liability. Still, that exposure is due to the system's commitment to trial-by-jury and a preponderance-of-the-evidence standard of proof; and these commitments may well entail benefits that adequately justify the misfortunes in question. Yet even if the system's unreliability in ascertaining liability can perhaps be tolerated as a necessary evil, for fairness purposes there is abundant appeal in at least allowing defendants voluntarily to protect themselves against that unreliability by the purchase of liability insurance.<sup>55</sup>

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245 (1986). However, so long as the legal system includes important principles of vicarious liability, such a characterization is unsatisfactory. A court's opinion may present a lawsuit against a bus company as a negligence case; in fact, however, the bus company is liable for its driver's negligence only because of a strict liability rule of *respondet superior*. Since the bus company has limited but imperfect control of its drivers' behavior, its strict liability is what should be emphasized here in considering the appeal of liability insurance.

<sup>54</sup> For a discussion of further implications of this point, see *infra* text accompanying notes 143-45.

<sup>55</sup> The previous paragraphs, insofar as they have highlighted the fairness of liability insurance, have assumed that liability insurance is voluntarily purchased by the individ-

There are, then, meaningful fairness advantages that liability insurance provides. Even so, the task remains of determining whether insurance is sufficiently consistent with the objectives that tort liability rules may be trying to achieve. My Article here assumes that tort law's basic justification can be found somewhere within principles of fairness. In an open-minded way, the Article now endeavors to identify and distinguish between the *general forms* of fairness arguments that might support tort liability rules; moreover, it seeks to illustrate these forms of argument by reviewing several specific fairness arguments that leading tort scholars have recently advanced.

The first form of argument to be considered here is that of retributive justice. Such an argument stipulates that a defendant, because he has acted in a certain improper way, should be required to bear the burden of liability for the resulting harm.<sup>56</sup> Now I, along with others,<sup>57</sup> am doubtful that any theory of retribution can go a long way towards explaining our current tort system. For one thing, such a theory clearly depends on the assumption that there is something distinctively wrongful in the defendant's conduct; hence the theory is ill-equipped to deal with tort rules of strict liability—even

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ual. On occasion, however, this country's system of accident law compels the purchase of insurance. For workers' compensation, compulsory insurance is part of the very conception of the liability program; for auto accidents, legislatures have superimposed a limited insurance obligation upon the ongoing system of common-law tort liability. In addition, the law includes a variety of somewhat ad hoc insurance requirements. For example, federal and state law currently subject passenger airlines to a number of liability insurance requirements. See 14 C.F.R. § 298.41-298.45 (1989) (federal requirements); ROD D. MARGO, AVIATION INSURANCE 17 (2d ed. 1989) (describing state requirements). In California, an odd statute imposes an insurance obligation on local school boards. CAL. EDUC. CODE § 35,208 (West 1989). In several states, recent malpractice reform statutes include provisions requiring medical professionals to secure liability insurance coverage. See F. Townsend Hawkes, *The Second Reformation: Florida Medical Malpractice Law*, 13 FLA. STATE U.L. REV. 747, 781-83 (1985). While this Article focuses on voluntary liability insurance, it also attempts to note at what points a compulsion to buy insurance would affect its analysis. At the outset it can be noted that the fact of compulsion obviously weakens the various ethical and welfare arguments in favor of liability insurance developed above.

<sup>56</sup> See David G. Owen, *Deterrence and Desert in Tort: A Comment*, 73 CALIF. L. REV. 665, 666 (1985).

Jules Coleman, in a quasi-retributivist vein, argues that one goal of accident law ought to be to require parties to surrender their "wrongful gains"—the gains that they have secured through their negligent wrongdoing. See Coleman, *supra* note 48, at 7.

<sup>57</sup> See, e.g., Williams, *supra* note 4, at 140-44; Jules L. Coleman, *Moral Theories of Torts: Their Scope and Limits: Part I*, 1 LAW & PHIL. 371, 372-76 (1982) [hereinafter Coleman, *Part I*].

Coleman appreciates that the current tort system cannot be characterized as a system that pursues or achieves the goal of annulling wrongful gains. See Coleman, *supra* note 48, at 7. Here Coleman relies partly on the point that while the negligent wrongdoer may benefit from his creation of a negligent risk, he does not actually profit by the fortuitous process by which risk is converted into the plaintiff's injury. In light of this, Coleman contends, corrective justice does not itself mandate that the defendant bear liability for that injury. See *id.* at 10-11.

the elemental rule that renders an employer automatically liable for its employee's negligence.<sup>58</sup> Secondly, even when the defendant is negligent, the retributive idea appears to require a degree of wrongfulness in his conduct that goes well beyond what the law frequently characterizes as negligence. As one considers, for example, the motorist who absentmindedly takes his eyes off the road, it is hard to see how his inattention deserves the response of retribution. Furthermore, retribution bears an awkward relationship to basic features of the tort process. Given that process, a defendant is subjected to liability if, but only if, his wrongful conduct happens to result in injury; this emphasis on the happenstance of an actual injury seems anomalous from the perspective of retribution. Also, in a tort action the magnitude of the defendant's liability depends primarily on the extent of the victim's injury in the individual case. For purposes of retribution, this is an emphasis that seems equally anomalous.

Yet my doubts notwithstanding, retribution has been supported as a principal tort objective by a number of traditional tort scholars.<sup>59</sup> Moreover, ideas of retribution play a significant role in how the public thinks about tort,<sup>60</sup> and perhaps even in the actual justification of particular tort doctrines. Notions of retribution can easily be found, for example, in the rhetoric that surrounds the collateral source rule, and perhaps in the rule itself.<sup>61</sup> Therefore it is certainly worthwhile to inquire into how liability insurance relates to whatever retributive goals tort law might harbor. This inquiry leads to an initial observation: flatly priced insurance obviously violates the retributive norm.<sup>62</sup> For given such insurance, the same monetary burden is borne by the wrongdoer and by the innocent (so long, at least, as they are both engaged in the same activity).<sup>63</sup>

An entirely different analysis, however, is invited by the practice

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<sup>58</sup> See *supra* note 53.

<sup>59</sup> See, e.g., JOHN SALMOND, *JURISPRUDENCE* 449 (11th ed. 1957).

Moreover, the *Breeden* dissent conceives of tort liability partly in retributive terms, referring to liability as a "penalt[y]" for wrongdoing. 220 Mo. at 368, 119 S.W. at 587.

<sup>60</sup> In an airplane-crash case that recently headed towards trial, one plaintiff made his objective explicit: "I want [the defendants] punished." N.Y. Times, Oct. 11, 1989, at A15, col. 3 (national ed.).

<sup>61</sup> See John G. Fleming, *The Collateral Source Rule and Loss Allocation in the Law of Torts*, 54 CALIF. L. REV. 1478, 1546-47 (1966).

<sup>62</sup> Glanville Williams concludes that liability insurance "seems to be inconsistent" with any norm of retribution. Williams, *supra* note 4, at 165. He does not realize that his conclusion does not hold to the extent that insurance is responsively priced.

<sup>63</sup> In one passage the *Breeden* dissent seemed to make this point: "Should a court of justice uphold such a policy of insurance and assist the self-confessed wrongdoer, who has wrongfully killed or injured his fellow man, to collect the policy, and thereby enable him to escape the penalties incident to his own wrong? I think not . . ." 220 Mo. at 368, 119 S.W. at 587.



of perfectly responsive insurance. This insurance renders the extent of the defendant's financial burden proportional to the level of improper risks that his conduct occasions.<sup>64</sup> One point here is that responsive insurance poses no threat to tort theories of retribution; a stronger point is that such insurance actually enhances tort law's ability coherently to perform the retributive function. As noted, from the standpoint of retribution tort law behaves curiously when it allows a defendant to be sued only when an accident occurs and when it measures the magnitude of a defendant's liability simply by the size of the plaintiff's injury. Responsive insurance eliminates these curiosities. The effective burden borne by the insured becomes a function of his risktaking rather than the fortuities of what accidents happen; and the extent of that burden becomes a function of average expected injury, rather than the fortuitous injury that a particular victim turns out to suffer.

A second form of argument in possible support of tort liability rules—call it compensatory justice—relates to the reparation of accident victims.<sup>65</sup> The essence of such an argument is that the defendant—having been involved in a certain way in the infliction of the plaintiff's injury<sup>66</sup>—is under an obligation to make sure that the plaintiff receives compensation for that injury. To whatever extent our tort regime builds on the premise of compensatory justice, liability insurance fares just fine.<sup>67</sup> In either responsive or flat forms, insurance not only is consistent with the compensatory-justice norm, but actually serves to further that norm. Admittedly, so long as the defendant's legal liability in the individual case is not in excess of his reachable assets, the insurance company's payment to the plaintiff merely replaces the payment that the plaintiff would have otherwise received from the defendant. Whenever, however, the tort judgment is for an amount greater than the defendant's wealth, the victim ends up more fully compensated on account of insurance than he otherwise would have been. Now consider potential defendants, such as inner-city motorists, who may be solvent enough to be able to afford an annual insurance premium, yet not so wealthy as to be able to bear a large tort liability. In these circumstances, statutes that actually require the purchase of auto liability insurance

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<sup>64</sup> Coleman, *Part I*, *supra* note 57, at 375-76, rejects a retributive view of tort law on grounds that tort imposes liability on defendants in ways that are out of line with their individual degrees of fault. He fails to see how responsive liability insurance could in fact achieve the kind of "at fault pool" that retributive reasoning seems to require.

<sup>65</sup> Williams labels this "ethical compensation." Williams, *supra* note 4, at 141.

<sup>66</sup> This sentence is drafted so as to leave open the question of whether the idea of compensatory justice requires negligence on the part of the defendant or is satisfied instead by a showing of causation alone. For various answers to this question, see *infra* text accompanying notes 71-74, 76.

<sup>67</sup> See Williams, *supra* note 4, at 141, 165.

may reveal a legislative attempt to effectuate the principle of compensatory justice by preventing motorists from relying on their limited solvency in order to evade their compensation obligation.<sup>68</sup>

Moreover, the capacity of liability insurance to further the objective of compensatory justice extends far beyond the motorist who operates under a limited insurance mandate. Consider the suburban motorist with \$50,000 in wealth who voluntarily buys a \$50,000 insurance policy, yet whose liability for negligent motoring might easily run to \$100,000; consider also the doctor with \$500,000 in assets but who, in the absence of a \$2,000,000 liability policy, would be unable to meet more than a portion of a \$1,500,000 malpractice judgment; consider, as well, the corporate defendant whose assets, though very substantial, might not be ample enough to pay for the cost of a mass tort disaster—an airplane crash, for example, or a hotel fire. In all these situations, the defendants' purchase of liability insurance assures more complete compensation for the victims of the defendants' torts and hence furthers the objective of compensatory justice. To be sure, in each situation the fact that the defendant's wealth is less than his potential liability gives him a partial *de facto* immunity from tort liability of the sort that could possibly discourage him from buying liability insurance. Nevertheless, such a defendant might be horrified by the prospect of descending into insolvency, or of otherwise incurring a sharp downward change in economic status. Because he might well place a high value on the basic wealth that provides a buffer against insolvency or such a change in status, his motives for voluntarily purchasing liability insurance might be especially strong.<sup>69</sup>

This favorable evaluation of the relationship of liability insurance to the principle of compensatory justice leads to the question whether it is plausible to believe that tort liability rules do (or should) appreciably depend on this principle. A previous article of mine considered the negligence liability rule that looms large in our existing torts regime.<sup>70</sup> In tending to justify that rule, the article suggested that "ethically regarded, the idea of liability for harm caused by one's unexcused errors and mistakes is both straightfor-

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<sup>68</sup> On the other hand, compulsory insurance raises problems of possible unfairness to defendants. See *supra* note 51.

For another possible interpretation of compulsory auto insurance, see *infra* note 200.

<sup>69</sup> For a previous treatment of the incentive effects of the disutility of bankruptcy, see Alan O. Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 567 n.9 (1988).

<sup>70</sup> See Gary T. Schwartz, *The Vitality of Negligence and the Ethics of Strict Liability*, 15 GA. L. REV. 963 (1981).

ward and intuitive."<sup>71</sup> As the spokesman for this intuition, I am in an acceptable position to consider its implications; and my own understanding is that compensatory justice is the form of argument on which the intuition draws.<sup>72</sup> As far as strict liability is concerned, Robert Keeton in a 1959 article explored certain categories of otherwise non-negligent conduct in which the common law, supported by the ethical sense of the community, disapproves of the defendant if he fails to make "reasonable provision for compensation of losses."<sup>73</sup> This explanation for existing strict liability obviously sounds in compensatory justice, and Keeton is explicit that a liability insurance policy is a suitable way for a defendant to discharge the obligation that his analysis affirms.<sup>74</sup>

Compensatory justice also invites a review of the normative tort theory espoused by Richard Epstein.<sup>75</sup> His position is that, at least in a significant number of cases, the imposition of liability need not

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<sup>71</sup> *Id.* at 1003. For a somewhat similar endorsement of strict liability, see *id.* at 1003-04.

<sup>72</sup> It might be argued that the collateral source rule is out of line with the idea of compensatory justice. But there are any number of justifications for that rule, many of which (for example, the likelihood of reimbursement arrangements between plaintiffs and health insurers that reduce the actual cost of health insurance) seem sufficiently consistent with that idea.

<sup>73</sup> Robert E. Keeton, *Conditional Fault in the Law of Torts*, 22 HARV. L. REV. 401, 426 (1959). Keeton is clear that he is here concerned with interpersonal fairness and not social loss-spreading. See *id.* at 443-44.

<sup>74</sup> See *id.* at 420.

<sup>75</sup> At this point Jules Coleman also deserves consideration; but since he is no more than half-hearted in his support of a tort system, his position can be dealt with in a footnote. In Coleman's view, a loss suffered by a plaintiff is a "wrongful loss" if it results from conduct by the defendant that contains some element of impropriety. Coleman, *supra* note 48, at 7. Accordingly, one primary goal of accident law should be restitution for those who have been subjected to such wrongful losses. *Id.* at 6. The essential role that Coleman assigns to restitution clearly aligns him with a compensatory justice understanding of tort law, and to this extent might render him enthusiastic about liability insurance, which better enables the defendant to provide the compensation in question. To be sure, Coleman's view, more fully stated, is that an enlightened accident law should strive *both* to compensate wrongful losses *and* to annul wrongful gains. While tort rules properly honor the plaintiff's "claim to repair," *id.* at 9, those rules work awkwardly with respect to expunging wrongful gains; hence Coleman was originally led to all but abandon tort law as a proper device for affording compensation. See *supra* note 57 and accompanying text. However, in his most recent work, Coleman has taken the position that since the defendant's negligence is "analytically connected" to the plaintiff's injury, a regime of defendant liability may be "administrative[ly] efficient" as a technique for financing a system that reimburses plaintiffs for their wrongful losses. See Jules L. Coleman, *The Structure of Tort Law*, 97 YALE L.J. 1233, 1250 (1988). This position at least approaches what is referred to here as compensatory justice, and hence seems quite supportive of liability insurance. On the other hand, in 1987 Coleman had relied on the factor of "deterrence" to justify the liability of tort defendants. Jules L. Coleman, *Property, Wrongfulness and the Duty to Compensate*, 63 CHI.-KENT L. REV. 451, 465 (1987). This reliance meant that his support of the tort system then depended on a certain combination of ethics and economics; hence he would have needed to worry about the possible inefficiency of liability insurance.

be dependent on negligence; rather, liability is appropriate whenever the defendant's conduct has clearly caused the plaintiff to suffer harm.<sup>76</sup> In explaining his views, Epstein emphasizes his own "pre-occupation" with "compensation" for the plaintiff,<sup>77</sup> a preoccupation that begins to align Epstein's theory with the ethic of compensatory justice. According to Epstein, if an actor, in the course of promoting his own advantage, happens to inflict damage on his own property, he of course bears the burden of that damage; just because in another situation the property damaged by the actor's conduct belongs to another, the actor should not escape the consequences.<sup>78</sup> This is a rationale for causation-based liability that casts clear light on the acceptability of insurance.<sup>79</sup> Insofar as injuries to one's own person or property are concerned, under contemporary law individuals clearly are free to protect themselves by the purchase of first-party insurance policies: health insurance, disability insurance, collision insurance, fire insurance, and so on.<sup>80</sup> Given Epstein's idea that "the defendant should be required to treat the harms which he has inflicted upon another as though they were inflicted upon himself"<sup>81</sup> and in light of that actor's undoubted ability to protect his own property through first-party insurance, the Epstein tort theory clearly implies that the actor's purchase of a liability insurance policy is unobjectionable.

Up until now, my discussion has dealt with retributive justice and compensatory justice. A third possible form of argument—here called corrective justice<sup>82</sup>—would in a way include elements of each.

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<sup>76</sup> See Richard A. Epstein, *A Theory of Strict Liability*, 2 J. LEGAL STUD. 151, 160 (1973).

<sup>77</sup> Richard A. Epstein, *Causation and Corrective Justice: A Reply to Two Critics*, 8 J. LEGAL STUD. 477, 488 (1979).

<sup>78</sup> See Epstein, *supra* note 76, at 158; for the same point, see RICHARD A. EPSTEIN, *TAKINGS* 40-41 (1985).

<sup>79</sup> Another Epstein rationale is that common-law rules should incorporate a common-sense, ordinary-language ethics—and that ordinary language calls for strict liability. See Epstein, *supra* note 76, at 151. While this rationale may not be especially helpful in thinking about liability insurance, it certainly can be noted that ordinary public opinion hardly seems hostile to the availability of liability insurance.

<sup>80</sup> Early American law cast doubt on the legality of first-party insurance policies that protected the insured against the consequences of his own negligence. See *Boatwright v. Aetna Ins. Co.*, 32 S.C.L. (1 Strob.) 281, 286-87; MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW* 228-31 (1977). These doubts have long since been dispelled. *Id.*

<sup>81</sup> Richard A. Epstein, *Intentional Harms*, 4 J. LEGAL STUD. 391, 398 (1975).

<sup>82</sup> Notice that this phrase here is used in much less than its full Aristotelian sense. Aristotle recognized a fundamental distinction between "what is just in distribution" and "what is just in correction." ARISTOTLE, *THE NICOMACHEAN ETHICS* 142, 145 (J.E.C. Welldon ed. 1892). All of the fairness forms of argument considered in this Section lie on the corrective justice side of the Aristotelian divide. (On the corrective justice features of retribution, see HERBERT MORRIS, *ON GUILT AND INNOCENCE* 34 (1976)). Though Aristotle identifies and provides some discussion of the corrective justice alter-

Corrective justice begins with the perception that it is only the combination of the defendant's tortious conduct and the plaintiff's injury that properly gives rise to tort liability. Building on this perception, corrective justice—like compensatory justice in this regard—concerns itself with compensation for the victim; but corrective justice—in this respect somewhat resembling retributive justice—emphasizes that the tort defendant, having created risks in a certain way, should serve as the actual source of the compensation payment.<sup>83</sup> Accordingly, from a corrective justice perspective flatly priced liability insurance undermines one of the two essential purposes of tort liability inasmuch as it places the burden of liability on all persons who engage in an activity, whether or not they conduct themselves in tortious ways.

Corrective justice provides a basis for considering the tort theory set forth by George Fletcher. That theory asserts that the proper ground for liability is the nonreciprocal risk imposed on the plaintiff by the defendant.<sup>84</sup> In Fletcher's view, victims of nonreciprocal risktaking have a right to compensation; this right signifies that even if a program of social insurance were to replace all of tort law, within that program the claims of such victims should enjoy the highest priority.<sup>85</sup> To the extent that Fletcher's theory rests on his sense of certain victims' entitlement to reparation, that theory includes a compensatory-justice feature that implies the acceptability of liability insurance. Fletcher's theory, however, also espouses the corrective-justice propriety of imposing liability on the party who engages in nonreciprocal risktaking. For Fletcher's purposes, the mere act of driving does not occasion nonreciprocal risks; yet an element of nonreciprocity is introduced when the driving is done in a negligent manner.<sup>86</sup> Flatly priced auto insurance, by allocating

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native, his account leaves open many questions. See Richard A. Posner, *The Concept of Corrective Justice in Recent Theories of Tort Law*, 10 J. LEGAL STUD. 187 (1981). In considering the overall Aristotelian concept, I have been able above to identify and sort out the two forms of justice arguments that respectively deal with retribution and compensation. Yet there is a third form of argument that likewise can be drawn from the Aristotelian concept; and for this argument the language of "corrective justice" seems properly evocative. It is in this limited sense, then, that the corrective justice term will be employed in the remainder of this Article.

<sup>83</sup> In a sense, corrective justice incorporates compensatory justice but then complicates it by imposing an additional requirement. It cannot quite be said, though, that corrective justice subsumes retributive justice, since the reason given by corrective justice for imposing liability on the defendant is somewhat distinct from the reason of retribution. Accordingly, certain features of the tort system that disturb the retributive analyst would not pose problems for the corrective justice analyst.

<sup>84</sup> George P. Fletcher, *Fairness and Utility in Tort Theory*, 85 HARV. L. REV. 537, 543 (1972). For a discussion of Fletcher and Epstein, see Schwartz, *supra* note 70, at 977-1005.

<sup>85</sup> See Fletcher, *supra* note 84, at 553-54.

<sup>86</sup> See *id.*

costs equally among all motorists regardless of the incidence of their negligence, would hence frustrate a vital half of what Fletcher wants tort law to achieve.<sup>87</sup> By contrast, responsively priced insurance avoids this frustration. Under this insurance, negligent motorists contribute assets to a pool of funds, which is then utilized to compensate victims of negligent motoring; for Fletcher's purposes, this would be a commendable result.

Fletcher's own version of corrective justice thus appears sympathetic to perfectly responsive liability insurance. Yet the corrective justice approach is capable of being asserted in an even more dramatic manner. According to Ernest Weinrib, what is essential for corrective justice is that the defendant's negligence be the actual cause of the injury which the plaintiff suffers.<sup>88</sup> Only through such causation are the defendant and the plaintiff "linked as doer and sufferer of the same harm;"<sup>89</sup> and only that linkage, in Weinrib's view, puts tort law in a position to achieve corrective justice. Weinrib gives examples of results that his corrective justice approach would rule out. Assume that *A* negligently injures *X* and that *B* negligently injures *Y*; in Weinrib's view, there would be no justice if (for some reason) *X* were allowed to recover from *B* and *Y* were allowed to recover from *A*.<sup>90</sup> Similarly, Weinrib considers a modification of *Summers v. Tice*<sup>91</sup> in which the court knows with certainty which of the two hunters fired the bullet that landed in the plaintiff's eye. Here, even though each hunter's negligence was equally directed at the plaintiff, because only one hunter's negligence actually caused the plaintiff's harm, Weinrib insists that individual liability is appropriate and shared liability wholly unjustified.<sup>92</sup> In a recent article, Steven Smith, while not acknowledging Weinrib, adopts a po-

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<sup>87</sup> For Fletcher, the general activity of operating trucks would probably be regarded as merely a part of the reciprocal risktaking involved in motoring generally; however, the special activity of trucking gasoline would probably count for Fletcher as a nonreciprocal risk. Fletcher would care greatly, therefore, about whether companies that provide liability insurance for truckers break out a special rate for trucking gasoline. On the question of how narrowly "activities" are defined in liability insurance, see *supra* note 21.

<sup>88</sup> Ernest J. Weinrib, *Causation and Wrongdoing*, 63 CHI.-KENT L. REV. 407 (1987).

<sup>89</sup> *Id.* at 415.

<sup>90</sup> *Id.* at 429; see also Ernest J. Weinrib, *Toward a Moral Theory of Negligence Law*, 2 LAW & PHIL. 37, 39 (1983). The example seems quite weak, since Weinrib provides no explanation as to why the law might seek to depart from the more conventional lawsuits of *X* versus *A* and *Y* versus *B*.

<sup>91</sup> 33 Cal. 2d 80, 199 P.2d 1 (1948). The modification was first developed by Judith Jarvis Thompson, in *Remarks on Causation and Liability*, 13 PHIL. & PUB. AFF. 101, 104-05 (1984).

<sup>92</sup> See Weinrib, *supra* note 88, at 412-16. On account of an absence of causation, Weinrib now opposes any recognition of affirmative duties in tort. See Ernest J. Weinrib, *Understanding Tort Law*, 23 VAL. U.L. REV. 485, 516-17 (1989). Weinrib evidently approves of *Summers v. Tice*, but only by emphasizing that its holding does no more than shift the burden of proof on the causation issue. *Id.* at 10-11 n.25.

sition towards liability that considerably resembles Weinrib's.<sup>93</sup> For Smith, the function of tort law is to resolve disputes that arise between parties in a manner that affirms society's basic norms. What enables tort law to resolve such a dispute is its ability to secure vindication for the plaintiff who has been injured on account of the defendant's violation of an appropriate norm.<sup>94</sup> And for purposes of achieving vindication, the compensation awarded to the plaintiff needs to come from the defendant himself, rather than from some third party or some public compensation program. "It seems as though receiving the compensation *from the harmdoer* is necessary to produce [the victim's sense of satisfaction]."<sup>95</sup>

Under the strong version of corrective justice adopted by Weinrib and Smith, flatly priced insurance clearly is unacceptable. Moreover, from their vantage points even perfectly responsive insurance would be an extremely doubtful practice: for that insurance entails a sharing of liability that in their view should rest on the harm-causer alone. This section has previously suggested that liability insurance promotes fairness by protecting the defendant against the vicissitudes and fortuities of risk. From the perspective of Weinrib and Smith, the identity of the harm-causer is not a fortuity at all; it rather is an essential ingredient in the formulation of a proper corrective justice remedy.<sup>96</sup>

As it happens, Weinrib seems never to have discussed the specific question of liability insurance within a corrective justice tort regime, except for his single observation that "liability is . . . antecedent to the operation of . . . insurance."<sup>97</sup> Smith does include an explicit discussion of liability insurance, and its implications are noteworthy. What he suggests is that fairness is adequately secured by "a finding of tortious conduct and the imposition of *some* sanction against the defendant, coupled with full compensation by the defendant's insurance carrier."<sup>98</sup> Moreover, "an increase in the defendant's insurance rates might constitute a sufficient sanction."<sup>99</sup>

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<sup>93</sup> See Steven D. Smith, *The Critics and the "Crisis": A Reassessment of Current Conceptions of Tort Law*, 72 CORNELL L. REV. 765 (1987).

<sup>94</sup> "Vindication" is my word, but it seems to best express the idea that Smith is driving at. See *id.* at 778-85. For another discussion of vindication as a tort objective, see PETER CANE, *ATTYAH'S ACCIDENTS, COMPENSATION & THE LAW* 486-88 (4th ed. 1987).

<sup>95</sup> See Smith, *supra* note 93, at 784 (quoting Andre de Carufel, *Victims' Satisfaction with Compensation: Effects of Initial Disadvantage and Third Party Intervention*, 11 J. APPLIED SOC. PSYCHOLOGY 445, 452 (1981)) (emphasis in Smith).

<sup>96</sup> But see *infra* note 104.

<sup>97</sup> Ernest J. Weinrib, *The Insurance Justification and Private Law*, 14 J. LEGAL STUD. 681, 683 (1985). Weinrib strongly opposes the insurance-oriented loss-spreading rationale for tort law. See *id.* at 683-85.

<sup>98</sup> Smith, *supra* note 93, at 795-96.

<sup>99</sup> *Id.* at 796 n.112.

By not requiring that all of the plaintiff's compensation come from the pockets of the defendant, Smith here withdraws from the strong version of corrective justice that he has previously staked out, so as to enable him to acknowledge the advantages of liability insurance. By accepting that full compensation can properly come from an insurer contracted for by the defendant, he is utilizing the central idea of compensatory justice.<sup>100</sup> By suggesting an additional requirement that the defendant bear some significant burden on account of the accident by way of an increased premium, Smith is reintroducing at least a moderate requirement of corrective justice as a supplement to compensatory justice. Since, in the real world, liability insurance usually is moderately or at least nontrivially responsive,<sup>101</sup> Smith's rationale for tort liability may be well suited for the task of justifying current tort arrangements.<sup>102</sup>

In any event, having by now canvassed several justice possibilities, I can now wrap up this section of the Article. In considering the question whether liability insurance complies with tort law's justice-dispensing function, the answer is that it all depends—it depends on which form of argument the justice analyst has in mind, and it depends as well on the extent to which the insurance in question is flatly or responsively priced. In all, there is an impressive range of possible outcomes as to the appropriateness of insurance in light of fairness criteria. Accordingly, the many scholars who unqualifiedly assert that liability insurance is inconsistent with fairness theories of tort law<sup>103</sup> are guilty of ignoring, for example, the possibility that compensatory justice is the theory that tort law has in mind—a theory that renders liability insurance not only acceptable but commendable. Those scholars also fail to realize the way in which responsive insurance pricing would make sense of retributive-justice theories and certain versions of corrective-justice theories as well; they likewise neglect the point that moderately responsive insurance can receive justification from a certain combination of com-

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100 Having earlier critiqued the relevance of the compensation goal to tort law, *id.* at 768-72, at this point in his argument Smith acknowledges the significance of compensation. *Id.* at 795.

101 Observe that Smith seems to be assuming insurance arrangements that are moderately responsive to actual liability and not just to *ex ante* risktaking. Thus experience rating would satisfy Smith, but schedule rating might not. Smith may be somewhat unclear as to exactly how responsive liability insurance needs to be in order to comply with his requirement of a "sufficient sanction." Consider a \$100,000 accident that results in a motorist's premiums being increased by \$150 for each of three years. This \$450 obligation is less than .5% of the plaintiff's entitlement. Nevertheless, it is hardly a token increase as far as the motorist is concerned.

102 In this respect it provides one indication of the insufficiency of the bipolar ideal-type strategy on which the Article generally relies.

103 See *supra* note 2.



pensatory justice and a moderate measure of corrective justice. Nevertheless, liability insurance, regardless of how it is priced, does seem inconsistent with the strong corrective justice theory advanced by a scholar such as Weinrib.<sup>104</sup>

In short, the impact of liability insurance on tort law's possible fairness objectives is a question that calls for a rather complex answer. How, then, does liability insurance relate to tort law when the latter is looked at from the perspective of the goal of efficient deterrence? This is the question considered in Section IV.

#### IV

#### LIABILITY INSURANCE AND DETERRENCE

Before discussing how deterrence theory works, it is useful to clarify the benefits that liability insurance, considered from an economic perspective, confers.<sup>105</sup> The primary benefit, of course, concerns the ability of insurance to enable parties to avoid unwanted risks.<sup>106</sup> A secondary benefit relates to the way in which an insurance policy—by including coverage for defense costs—eliminates the burden that a defendant would otherwise bear in attempting to review or monitor the performance of the lawyer he would need to hire if he were uninsured.<sup>107</sup> That lawyer, through slack or the press of other business, might tend not to work hard enough or long enough on the defendant's case; alternatively, the lawyer, remunerated by an hourly fee, might be inclined to overprepare the case, to "milk the file." These are distinctly disadvantageous possibilities that the defendant can avoid by acquiring a liability insurance policy, which combines the burden of defense and the burden of liability within a single specialized entity.<sup>108</sup>

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<sup>104</sup> One of the protections afforded by liability insurance—the protection against the risk of fortuitous causation—Weinrib would not regard as an advantage at all. *See supra* text accompanying note 96. Still, Weinrib might well appreciate liability insurance insofar as it protects an individual against the prospect of error and uncertainty in the application of tort standards. *See supra* text accompanying note 55. It is unclear to what extent this factor would incline Weinrib to modify the anti-insurance import of his strong corrective justice position.

<sup>105</sup> To be sure, liability insurance is responsible for certain diseconomies as well. For example, all American policies include some cap on coverage. *See supra* text accompanying note 16. When there is a plausible claim for an amount in excess of that cap, defending against the total claim will place a costly burden of coordination on the insurer and the insured. *See supra* note 18. For a treatment of the liability implications of imperfect coordination, see *Crisci v. Security Ins. Co.*, 66 Cal.2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

<sup>106</sup> *See supra* text accompanying notes 37-41.

<sup>107</sup> For a related point, see PATRICIA M. DANZON, *MEDICAL MALPRACTICE* 127 (1985).

<sup>108</sup> The benefit that liability insurance affords the defendant in relieving him of concern about his lawyer's effort can be compared to the somewhat similar benefit that the contingent fee bestows on the plaintiff.

If liability insurance thus facilitates these economic benefits, what are its detrimental effects on tort law's economically-minded deterrence goals? The economists' analysis of how tort liability rules might achieve efficient deterrence has been prominent in the tort literature during the last twenty years, and can easily be illustrated. Assume that a safety precaution would cost a defendant \$700 but would eliminate a risk whose magnitude is \$1000 (for example, a one percent chance of a \$100,000 injury). Under the negligence standard, as elaborated by Learned Hand,<sup>109</sup> the threat of tort liability gives defendants an incentive to avoid negligence—that is, to adopt such precautions the cost of which is less than the magnitude of the risk that the precaution would eliminate.<sup>110</sup> If a rule of strict liability applies, then defendants of course retain the incentive to adopt all reasonable-cost precautions. Furthermore, under strict liability defendants have incentives to avoid risky activities, to monitor and control the level of the risky activities they do engage in,<sup>111</sup> and to undertake appropriate projects in safety research-and-development.<sup>112</sup> Here the objective is for defendants to engage in activities and undertake R & D in a reasonable-cost way; if strict liability is needed, it is because of the likelihood that judges will regard such questions as the reasonableness of an entire activity as beyond the judicial function.<sup>113</sup>

Given these standard explanations of liability-rule deterrence, it is easy to see that perfectly responsive insurance poses no problem. Covered by such insurance, a party who engages in a certain activity and who declines to adopt the safety precaution will encounter a high premium. Since he can reduce this premium by \$1000 by purchasing a \$700 safety precaution, he has a full incentive to make that purchase; tort law's deterrence objectives are hence preserved.<sup>114</sup> Indeed, in one way liability rules combined with such in-

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<sup>109</sup> See *United States v. Carroll Towing Co.*, 159 F.2d 169 (2d Cir. 1947).

<sup>110</sup> The *Breeden* dissent embraced the economic view of negligence liability. Absent such a liability rule, the self-interest of a defendant "would dominate [him] and induce him to adopt the mode most profitable to himself, even though that mode should be more hazardous to the life and limb of [a potential victim]." 220 Mo. at 363, 119 S.W. at 585. For the views of the *Breeden* majority, see *infra* note 116.

<sup>111</sup> See S. SHAVELL, *supra* note 3, at 21-26. See generally W. LANDES & R. POSNER, *supra* note 3, at 64-73.

<sup>112</sup> See Guido Calabresi & John T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1063 (1972).

<sup>113</sup> See W. LANDES & R. POSNER, *supra* note 3, at 70-71.

<sup>114</sup> His situation closely resembles that of the uninsured defendant, who, by incurring a safety expense of \$700, can avoid a liability whose expected value is \$1000 (a one percent chance of a \$100,000 liability). These two situations differ only insofar as the latter calls into play the defendant's attitude towards risk. A risk-preferring defendant might well choose to face a one percent chance of a \$100,000 liability rather than to incur a \$700 safety expenditure. The defendant who is a risk preferrer, however, would

surance might produce even better safety results than liability rules standing on their own: for a liability insurer may be able to offer safety advice to an insured that will permit the latter actually to improve the level of safety it provides. The logic of this possibility will be dealt with more fully below.<sup>115</sup>

Flatly priced insurance, however, poses an obvious threat to the tort objective of inducing proper precautions. The defendant who buys such an insurance policy may have no incentive to adopt the \$700 precaution, since any liability averted by doing so falls on the insurer rather than on the insured himself.<sup>116</sup> Possibilities like this are well known to economists, who have long discussed the general phenomenon of "moral hazard";<sup>117</sup> their point is that an insurance policy can release the insured from cost constraints in a way that affects how he arranges his conduct.<sup>118</sup>

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be strongly inclined not to buy liability insurance in the first place; therefore, the question of how such insurance would alter his behavior effectively washes out. If the defendant is either risk neutral or risk averse, then in the absence of insurance he would certainly be willing to incur a \$700 safety expenditure in order to avoid a \$1000 liability risk. In addition, without insurance the risk-averse defendant, at least if he is operating under a rule of strict liability, might seriously consider incurring even a \$1300 safety expenditure in order to avoid the one percent prospect of a \$100,000 liability. Apart from the defendant's risk aversion, however, this is an expenditure that does not make social sense; accordingly, a liability insurance policy that enables him to avoid this risk seems socially advantageous. For a similar analysis, see S. SHAVELL, *supra* note 3, at 211.

<sup>115</sup> See *infra* text accompanying notes 185-90.

<sup>116</sup> This, indeed, was the primary objection to liability insurance advanced by the *Breeden* dissent. Liability insurance "has a direct and potent influence in encouraging negligence." 220 Mo. at 351, 119 S.W. at 581. Because of liability insurance, "the pecuniary consideration and incentive which prompts and induces [the defendant] to exercise due care is removed and destroyed." *Id.* at 363, 119 S.W. at 586. The *Breeden* majority, however, adopted a quite different position. According to the majority, "A predisposition to . . . neglect or any form of wrong is never *presumed* by the law." *Id.* at 433, 119 S.W. at 609 (emphasis in original). Judges therefore should not assume that "indemnity against losses by negligence will, in and of itself, induce [a defendant] to omit the highest degree of care." *Id.* at 430, 119 S.W. at 608. "[T]he existence of an indemnity fund does not directly or necessarily cause [a defendant] to relax his care and diligence . . ." *Id.* at 429-430, 119 S.W. at 608.

Whether or not the *result* reached by the *Breeden* majority in affirming the legality of liability insurance is economically correct, the *reasoning* which the majority employed entails a rejection of economic norms.

<sup>117</sup> The concept was already familiar in the literature by 1921. See FRANK H. KNIGHT, *RISK, UNCERTAINTY, AND PROFIT* 249, 251 (1921).

"Moral hazard" is sometimes distinguished from "morale hazard," the former referring to deliberate acts like arson, the latter to the mere relaxation of the defendant's discipline of carefulness. See C. ARTHUR WILLIAMS & RICHARD M. HEINS, *RISK MANAGEMENT AND INSURANCE* 217 (4th ed. 1981). In this article, "moral hazard" includes each of these possibilities.

<sup>118</sup> Much of the economic discussion of moral hazard has taken place in the setting of first-party insurance. In this setting, the real-world significance of moral hazard is easy to demonstrate. For example, patients who are covered by health insurance policies providing 100% reimbursement consume a far higher volume of medical services than do patients whose insurance policies include a substantial cost-sharing provision.

Before considering the extent to which moral hazard may impugn the efficiency of completely flat insurance,<sup>119</sup> we need to worry about the very availability of that insurance in light of a proof recently developed by Professor Shavell.<sup>120</sup> Call this Shavell's First Insurance Proof, which has been acceded to by Judge Posner<sup>121</sup> and Professor Polinsky.<sup>122</sup> Consider a negligence liability rule and return to the \$1000 risk that the defendant can eliminate through a \$700 safety expenditure. If the defendant has a completely flat insurance policy, it would seem that moral hazard evidently would induce him to forego that expenditure and allow the risk to materialize. However, this is defendant behavior that an intelligent insurer would be in a good position to predict. Therefore, \$1000 is the minimum premium that an insurer would set: that is, the premium would include a substantial moral-hazard surcharge. If the

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See Joseph P. Newhouse, William G. Manning, et al., *Some Interim Results from a Controlled Trial in Health Insurance*, 305 NEW ENGLAND J. MEDICINE 1501 (1981). Moral hazard reached the sports world in 1981, when a Lloyd's of London policy insuring baseball owners in the event of a strike evidently encouraged those owners to adopt bargaining policies that greatly increased the likelihood of a strike.

In Japan, a golfer who shoots a hole-in-one is subjected—not by law, but rather by social custom—to an obligation or “liability” to host lavish celebrations for friends and business associates. Many golfers in recent years have purchased liability insurance to protect them against the burden of this entertaining obligation. Yet with such insurance policies in place, some golfers have colluded with their caddies to create the false impression of holes-in-one—thereby entitling themselves to elaborate entertainment at the insurer's expense. See E.S. Browning, *A Stroke of Luck is Bad News in Japan if One Isn't Insured*, Wall St. J., Aug. 12, 1985, at 1, col. 4. Insurers now are considering withdrawing from this market. *Id.*

119 The text here accepts the economists' basic assumptions as to the deterrence efficacy of tort liability rules. However, many scholars, relying on a range of what they regard as realistic observations, contend that tort law is all but useless as a technique for deterrence. See, e.g., Sugarman, *supra* note 2, at 559-90; see also William H. Rodgers, *Negligence Reconsidered: The Role of Rationality in Tort Theory*, 54 SO. CAL. L. REV. 1 (1980) and Howard A. Latin, *Problem-Solving Behavior and Theories of Tort Liability*, 73 CALIF. L. REV. 677 (1985) (both contending that tort law is ineffective in deterring the misconduct of private individuals). The relevance of these realist critiques of deterrence theory to an efficiency analysis of flatly priced insurance is both obvious and ironic. On the obvious side, if tort law, even with insurance absent, fails to deter, then there is no actual deterrence that the introduction of insurance might undermine. With no losses to balance against the gains that insurance occasions, the efficiency of insurance becomes easy to affirm. Yet ironically, this argument provides support for the efficiency of flatly priced insurance only by rejecting the efficiency rationale originally offered in support of tort liability rules.

Other analysts might conclude that tort law, in the absence of insurance, achieves something quite significant by way of deterrence—but that its deterrence success is still much less systematic than that implied by standard economic accounts. This intermediate appraisal of the potential for deterrence would lead to an intermediate concern for the moral-hazard implications of flatly price insurance.

120 See S. SHAVELL, *supra* note 3, at 211-12.

121 See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 187 (3d ed. 1986).

122 See A.M. POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 70-73 (2d ed. 1989).

defendant ponders not buying such an insurance policy, he will realize that he can defeat the prospect of liability by incurring an expense of only \$700. That is, it is cheaper for the defendant to protect himself against liability by avoiding negligence than by purchasing liability insurance. Accordingly, a defendant will decline to make that purchase and will instead abstain from negligent conduct.<sup>123</sup> A corresponding analysis applies to the situation of the defendant who is offered a responsively priced insurance policy to cover the risk of negligence liability. If such a defendant buys the policy and then fails to incur the \$700 expenditure, the price of insurance will rise by \$1,000. The prospect of this, however, will induce the defendant to act non-negligently: that is, to incur the \$700 cost. But so long as he decides to adhere to non-negligent practices, he has no need to buy the insurance policy, and hence will decline to do so.

In one important way the inhibition on insurance availability that Shavell identifies seems even more dramatic than his Proof suggests. That Proof assumes that the insurance policy applies to a defendant's course of conduct that runs the risk of a single injury.<sup>124</sup> If there is only one such threatened injury, then the liability insurer is at least able to calculate an appropriate premium that takes the prospect of moral hazard into account (though the premium may be higher than anything the defendant is willing to pay). Most insurance policies, however, cover all injuries that occur in the course of a particular duration, usually one year. Whatever the number of such injuries might annually be in the absence of insurance, once a liability policy is in place its moral-hazard care-reducing effects might increase the number of possible injuries in an almost indefinite way. If so, then moral hazard might make it almost impossible for the insurer to even quote a price at which it would be willing to sell an insurance policy.

In this respect, Shavell's Proof is even more potent than he seems to realize. To further assess its potency, we should consider the standards of tort liability to which it applies. While Shavell de-

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<sup>123</sup> A related problem of adverse selection also can pose a threat to the viability of liability insurance. This problem relates to those parties whose tortious conduct—for example, selling defective products, or creating dangerous conditions on property—may have taken place before they apply for liability insurance, even though no injuries have yet occurred.

In addition, since the Law of Large Numbers on which insurance rests assumes that the risk posed by each insured is independent, liability insurance becomes problematic when risks among insureds are highly correlated. For example, the risk that courts will expand liability rules during the life of insurance policies is a risk that is common among all insureds. See Patricia M. Danzon, *Tort Reform in Private Insurance Markets*, 13 J. LEGAL STUD. 517, 536 (1984).

<sup>124</sup> See S. SHAVELL, *supra* note 3, at 207, 209.

velops his Proof solely in the context of negligence liability, everything that he says about liability for negligent harms obviously applies with equal or greater force to liability for intentional torts. Indeed, in this respect actual insurer practices tend to confirm the Proof. Insurance policies typically contain an exclusion for "intentional" harms,<sup>125</sup> and the standard explanation for this exclusion is that intentional harms are under the control of the insured in a way that makes insurance inadvisable.<sup>126</sup> Likewise, nuisance liability is frequently excluded from insurance policies—for the apparent reason that a nuisance is a "highly expectable" consequence of the insured's deliberate choice of conduct.<sup>127</sup>

What is the relevance of Shavell's Proof, however, to strict liability? Since his Proof rests on the ability of a defendant to avoid liability in a reasonable-cost way, Shavell seems to assume that his Proof has no major application to strict liability situations.<sup>128</sup> Yet this is a concession that seems excessive, at least when insurance is flatly priced. In many of the cases covered by a strict liability rule, the prospect of liability is indeed economically unpreventable—the defendant is not able to eliminate individual risks in a reasonable-cost fashion. For these cases, the defendant who is averse to the prospect of liability will clearly have an incentive to insure. Yet for some proportion of the instances covered by the strict liability rule, the defendant may in fact be in an appropriate position to eliminate risks. Flat insurance could, however, eliminate his interest in taking advantage of this position. Perceiving this, insurance companies offering this insurance will include a moral-hazard surcharge in their

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<sup>125</sup> See ROBERT E. KEETON, *supra* note 8, at 286-87, 292-93. The basic notion here is that intentional harms are not sufficiently "fortuitous" to justify insurance. *Id.* at 286-87. The intentional harm doctrine is a blend of a public-policy prohibition and an "implied exception" read into the insurance policy. See *id.* at 292-93. Note that the insurance concept of intentional harm can be considerably narrower than the doctrinal concept of intentional tort. See *id.* at 287, 293.

<sup>126</sup> See *id.* at 297-98.

<sup>127</sup> *Id.* at 298-99.

<sup>128</sup> See S. SHAVELL, *supra* note 3, at 211. Shavell does suggest, however, that the insurance policy can be expected to provide less than complete coverage. *Id.* He is very vague, however, as to the form of partial insurance that he has in mind. See *id.* at 193, 204, 223. And he ignores the significant coordination costs that commonly accompany partial insurance arrangements. See *supra* notes 17, 18, 105.

When defendants are covered by a strict liability rule, insurers could possibly offer reduced-premium policies that would exclude coverage when the insured's conduct is negligent in fact. But because of the risk of error in adjudicating negligence and the partial uncontrollability of negligent conduct, defendants would find such offers of insurance unattractive. Alternatively, insurance policies might exclude certain well defined and clearly controllable instances of negligence (for example, failing to fence in a swimming pool). However, I have rarely heard of actual exclusions of this sort. Insurers do routinely exclude intentional harms; also, they sometimes exclude specific high-risk activities (for example, trampolines on public-school playgrounds).

price; facing that surcharge, the insurance applicant may well be able to economize by reducing risks as an alternative to purchasing insurance. On balance, then, for defendants who are subject to a rule of strict liability, whether it is or is not intelligent to purchase flatly priced insurance depends on a number of variables, including *both* the composition of the instances of conduct covered by the rule *and* the extent of the defendant's risk aversion relative to those risks that the defendant is unable to eliminate through a reasonable effort.

Shavell's First Proof in this way merits partial extension into the territory covered by strict liability. Moreover, in this partially extended form the Proof can again be confirmed by real-world observations. One broad instance of confirmation is provided by the field of liability *ex contractu*. Consider the builder who enters a contract to complete a certain structure within two years. His ability to comply with his contract will depend, to a considerable extent, on the operation of chance—what happens over time, for example, to the price and availability of the labor and materials he will need.<sup>129</sup> Still, to a major extent his ability to satisfy the contract and hence avoid liability will depend on the effort he exerts in seeking to comply with the contract. Insurance companies firmly believe, however, that the protection afforded by a liability insurance policy would substantially reduce the effort that the builder would be willing to put forth. Given this belief, insurance companies are usually unwilling to offer insurance for breach-of-contract liability.<sup>130</sup>

The expanded version of Shavell's First Proof also receives confirmation from practices within the actual world of tort. The cost of liability insurance soared for many lines of insurance during the mid-1970s; it exploded all over again in the mid-1980s. As a response to each of these insurance crises, many institutions—whose liability primarily rests on strict liability principles, especially vicarious liability<sup>131</sup>—concluded that they could reduce their overall costs by curtailing insurance coverage while at the same time setting up ambitious programs of risk management—programs that are evidently effective in reducing the number of liability-producing incidents. The Southern California Rapid Transit District provides one example of an institution that has moved in the direction of self-

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<sup>129</sup> Of course, the builder, seeking to avoid these risks, can contract for future delivery of goods and services.

<sup>130</sup> Construction contracts often require the contractor to obtain a performance bond for the face amount of the contract. Any default by the contractor then gives his victim the benefit of the bond. However, the bonding company, as a surety, can claim reimbursement from the contractor; accordingly, such a bond does not raise the moral hazard problem that is associated with actual liability insurance.

<sup>131</sup> See *supra* note 53.

insurance and risk management;<sup>132</sup> UCLA affords another example.<sup>133</sup> In 1978, the spokesman for one pool of newly self-insured hospitals in Alabama reported that "being self-insured, our members have become much more safety conscious, and we've reduced our claims payouts to about one-third of what they used to be."<sup>134</sup> A 1988 *Newsweek* article on "The Surge in Self-Insurance" reported that "once self-insured, companies often become safety zealots" and then enumerated a number of safety measures that newly self-insured entities had implemented.<sup>135</sup>

These various illustrations encourage a general observation. In our society, there is a tendency for people to assume that for liability insurance to be unavailable signifies some breakdown in the overall functioning of the tort system.<sup>136</sup> But such an assumption may well be misguided. The unavailability of insurance—far from revealing that the system is malfunctioning—may verify that it is functioning very effectively as a deterrence regime: that it is targeting for liability precisely those forms of conduct that are so readily controllable by defendants as to render unacceptable to insurers the moral-hazard prospect of insurance policies.<sup>137</sup> Admittedly, I should be careful in not pushing this point too far. It is difficult to interpret the mid-1980s crisis in insurance availability as a consequence of moral-hazard considerations: for it is implausible that the prospect of moral hazard had become vastly more serious, in any general way, between 1980 and 1985. Nevertheless, at least selected aspects of the recent insurance crisis do invite being interpreted along the lines of moral hazard. The refusal of insurance companies to write policies for pollution torts unless they are "sudden and acciden-

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<sup>132</sup> Telephone interview with Chauncey Isom, SCRTD Risk Management Office (July 19, 1989).

<sup>133</sup> Telephone interview with Robert Torres, UCLA Risk Management Department (July 19, 1989).

<sup>134</sup> See Christopher Evans, *To Cut High Premiums Costs, More Firms and Institutions are Insuring Themselves*, Wall St. J., April 14, 1978, at 36, col. 1.

<sup>135</sup> See *The Surge in Self-Insurance*, NEWSWEEK, March 7, 1988, at 74; see also Michael Brody, *When Products Turn to Liability*, FORTUNE, March 3, 1986, at 20, 23:

The crisis in liability insurance has made risk management a main concern for top corporate decision-makers," says Robert H. Malott, chairman of FMC Corp. . . . Like other sophisticated corporations, FMC uses "preventive law" programs to reduce the company's exposure to suits. Such programs can include a so-called legal audit of a corporation's businesses, identifying products, services, or manufacturing operations that could trigger lawsuits, and either cleaning them up or scrapping them.

<sup>136</sup> See, e.g., George J. Church, *Sorry, Your Policy is Cancelled*, TIME, March 24, 1986, at 16.

<sup>137</sup> For an interesting yet curious argument that problems of adverse selection caused this crisis, see Priest, *supra* note 37, at 1539-40.



tal"<sup>138</sup> and the insistence of directors-and-officers insurers on excluding coverage for the action taken on merger offers<sup>139</sup> may well be due to insurers' assessments that the gradual release of pollutants and the rejection of takeover offers are so within the defendants' control as to render inadvisable a regime of insurance.

In any event, there is ample reason to believe that Shavell's First Proof contains an important message as to insurance availability. Nevertheless, even in its prime application to insurance for negligence liability, the Proof seems too strong. What the Proof tends to predict is an absence of such insurance out there in the real world. At this point, however, reality seems to confound the Proof's prediction. It is true enough that self-insurance has become increasingly common in the programs of large institutions. Still, almost every doctor purchases a very substantial liability insurance policy, as do many other professionals who face a substantial prospect of malpractice liability. Ordinary homeowners routinely purchase liability insurance against the threat of homeowner's liability, which is essentially based on a negligence principle. Even before auto insurance became quasi-mandatory, almost half of all American motorists purchased liability insurance to cover the risk of negligence liability;<sup>140</sup> currently, in an era of mandatory insurance, most motorists purchase auto insurance at levels well in excess of legal requirements. In all, there is a huge market for all of these insurance policies.

How, then, should the Proof be reconciled with the evidence of a strong market for negligence liability insurance? One explanation is provided by Shavell himself, who connects the motives for purchasing insurance to problems of "uncertainty over the determination of negligence"—the possibility of a defendant being found negligent "through some type of error or lapse" on the part of the fact-finder.<sup>141</sup> As explained above, the risk of error in adjudicating a

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<sup>138</sup> See Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 COLUM. L. REV. 942, 952-54 (1988).

<sup>139</sup> There also may be an adverse-selection explanation for the exclusion of merger decisions in D&O insurance: directors may be especially likely to apply for that insurance if they are privately aware that during the insurance year they will likely be voting on risky corporate deals. See George L. Priest, *Understanding the Liability Crisis*, in NEW DIRECTIONS IN LIABILITY LAW 196, 210 (Walter Olson ed. 1988).

<sup>140</sup> See Richard C. Wagner, *Safety Responsibility Laws—A Review of Recent Developments*, 9 GA. B.J. 160, 166 (1946).

<sup>141</sup> See S. SHAVELL, *supra* note 3, at 212. This point is also made and emphasized by Posner. R. POSNER, *supra* note 121. It is made—but deemphasized—by Polinsky. See A. M. POLINSKY, *supra* note 122, at 71 n.45. See also P. DANZON, *supra* note 107, at 124-25, suggesting that the legal system frequently errs in *not* holding doctors liable when they are guilty of malpractice, and claiming that the prospect of this error encourages doctors to purchase malpractice insurance. Danzon's presentation here is much too terse; but her point may well be that when the primary prospect facing defendants is the under-

defendant's liability is one of the risks against which he might seek to protect himself through insurance, and this is a risk that he cannot stave off merely by adopting reasonable-cost precautions.<sup>142</sup> So far, the problem has been characterized as one of prospective jury error. But once again, a related problem concerns the inherent uncertainty in basic tort concepts. Much of the time, for example, the numbers deemed controlling by the Hand negligence formula simply are not available in the real world: the defendant cannot consult those numbers at the time he acts, and the jury cannot rely on these numbers at the time it decides.<sup>143</sup> Accordingly, even though the defendant makes an intelligent effort to avoid negligence in his conduct, there is still a clear possibility that even an intelligent jury will render a finding of negligence.<sup>144</sup> To be sure, given the variables that the Hand formula identifies, in many cases a finding of negligence (or non-negligence) can easily and properly be rendered. In other cases, however, the negligence standard—which economists tend to treat as though it were characteristically capable of producing objective, clear-cut results—is instead surrounded by a considerable degree of unknowability.<sup>145</sup>

The points so far have concerned the defendant's imperfect ability to avoid liability under the negligence standard. Observe, however, that an insurance policy protects the insured not only from the cost of actual liability but also from the cost of mounting a legal defense against claims of negligence that the jury may eventually find to be unmeritorious. Even if the Proof is correct in supposing that a defendant can avoid negligence at a cost less than the cost of a liability insurance policy, it does not follow that he can, by incurring reasonable costs, avoid all the conduct that might give rise to an ultimately unsuccessful tort claim. The way in which every claim, regardless of its ultimate merits, can subject defendants to substantial defense costs provides another explanation for the demand for negligence liability insurance.<sup>146</sup>

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enforcement of valid claims, defendants will tend to indulge in negligence whether they are insured or not.

<sup>142</sup> See *supra* text accompanying note 54.

<sup>143</sup> Hand himself fully appreciated this. See *Moisan v. Loftus*, 178 F.2d 148, 149 (2d Cir. 1949).

<sup>144</sup> See *supra* text accompanying note 54.

<sup>145</sup> Consider, for example, the question "what is the value of life?"—a question that can arise in many negligence cases in which the defendant's conduct entails some risk of a fatal accident. For the wide range in economists' estimates of life value, and for discussions of the real vulnerabilities in their methodologies, see JOHN H. MENDELOFF, *THE DILEMMA OF TOXIC SUBSTANCE REGULATION* 22-52 (1988); Ronald G. Ehrenberg, *Workers' Compensation, Wages, and the Risk of Injury*, in *NEW PERSPECTIVES ON WORKERS' COMPENSATION* 71, 78-81 (John F. Burton ed. 1988).

<sup>146</sup> To be sure, this point may well be an offshoot of earlier points concerning the risks of jury error and the range of uncertainty in jury decision-making. If plaintiffs (and

The combination, then, of the costs of defending against unmeritorious suits, the costs of being subjected to liability when the jury errs, and the chance of bearing liability when there is genuine uncertainty in the negligence standard provides an explanation for why many defendants, despite Shavell's First Proof, purchase negligence liability insurance. And as it happens, this explanation seems supported by certain real-world practices.<sup>147</sup> Still, in my judgment the explanation is no more than partial. A defendant's concern with the costs of litigation would induce him merely to buy an insurance policy whose coverage would be limited to litigation costs; and if his concern ran to the risk of liability on account of dubious negligence findings, then the policy he would want to purchase might exclude coverage of all instances of clear, undeniable negligence. Nevertheless, the typical insurance policy—while containing an exclusion for intentional harms—provides nearly comprehensive coverage for harms resulting from negligence. Not even gross negligence or recklessness is excepted.<sup>148</sup>

Given the insights afforded by Shavell's First Proof, how should the existence of these policies be interpreted? As an economist, Shavell primarily relies on the conventional economic understanding of negligent conduct.<sup>149</sup> As Bruce Ackerman points out, from the economist's perspective "there can be no such thing as an accident";<sup>150</sup> negligence essentially consists of a defendant's deliberate choice to engage in conduct the riskiness of which he distinctly ap-

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defendants) could fully anticipate in advance that defendants *will* secure jury verdicts in all cases in which defendants *should* secure such verdicts, then plaintiffs would have no apparent incentive to file the suits that give rise to such verdicts—suits that require defendants to incur defense costs in order to bring those verdicts about.

<sup>147</sup> Doctors, for example, plainly are dismayed by the expensiveness of defending against malpractice claims and by the prospect of what they regard as improper or uninformed jury deliberations. Manufacturers complain of the shagginess of the negligence-like risk-benefit tests, *see, e.g.*, *Turner v. General Motors Corp.*, 584 S.W.2d 844 (Tex. 1979), which, as applied by the jury, determine their liability in design defect cases. *See, e.g.*, Brody, *supra* note 135:

But preventive law can do only so much. No matter how carefully decisions on product design have been documented and justified, it is virtually impossible to prove to a court equipped with 20/20 hindsight that a design could not have been improved upon. Riddell, whose football helmets protect the pros, was recently slapped with a \$12-million judgment in the case of a high school football player who broke his neck in a scrimmage. The jury decided the helmet should have carried a sticker warning players of the danger of butting opponents with it. Riddell has appealed the case.

<sup>148</sup> *See R. KEETON, supra* note 8, at 298-99. To be sure, a gross negligence exclusion might invite extensive (and expensive) litigation.

<sup>149</sup> *But see infra* note 155. *See also S. SHAVELL, supra* note 3, at 213, where Shavell, in discussing motives to buy insurance, refers very tersely to conduct that defendants "are unable to control."

<sup>150</sup> BRUCE A. ACKERMAN, *RECONSTRUCTING AMERICAN LAW* 50 (1983).

preciates. The very rationale for negligence liability endorsed by economists builds on the assumption of the defendant's rational choice among alternative courses of conduct, an assumption that likewise underlies Shavell's First Proof.

Nevertheless, this is an assumption of behavioral rationality that most of us non-economists would find somewhat excessive. To be sure, our own understanding acknowledges that many instances of possibly tortious conduct—for example, a manufacturer's selection of a design for its product—do comply with the norm of rational choice. However, our understanding is that many *other* instances of negligence seem essentially unchosen and inadvertent—obvious instances of what the layman indeed refers to as “accidents.”<sup>151</sup> A substantial fraction of negligent driving seems in this sense accidental; moreover, many instances of medical malpractice evidently entail no more than a “momentary lapse of a doctor acting under the pressure of a busy practice.”<sup>152</sup> Now in suggesting here that there is a range of inadvertent negligent conduct that is imperfectly controllable, I should not be understood as claiming that this conduct is not controllable at all.<sup>153</sup> Most motorists avoid bad driving most of the time; similarly, most doctors usually are able to avoid malpractice. The operation of normal first-party incentives, as supplemented by tort liability incentives, is commonly effective in discouraging this negligence. One can, however, concede all of this while still observing that a defendant's power to prevent inadvertent negligence is much less than complete; and so long as the defendant appreciates this point, he will have a reason to buy a negligence insurance policy.<sup>154</sup>

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<sup>151</sup> “The present inability of economists to model lapses [in parties' behavior] is a serious weakness in the economic analysis of law.” Robert D. Cooter, *Punitive Damages for Deterrence: When and How Much?*, 40 ALA. L. REV. 1143, 1174 (1989). For my earlier effort to draw attention to this weakness, see Gary T. Schwartz, *Contributory and Comparative Negligence: A Reappraisal*, 87 YALE L.J. 697 (1978).

<sup>152</sup> P. Weiler, *supra* note 2, at 10. For a similar account of how malpractice happens, see JEFFREY O'CONNELL, *THE LAWSUIT LOTTERY* 26 (1979), which suggests that “[o]verwhelmingly accidents are just that—‘accidents’”.

<sup>153</sup> Of course, a person can reduce the likelihood of negligent motoring by deciding not to drive, and a doctor can reduce the likelihood of inadvertent malpractice by seeing fewer patients per day. These are, however, not the choices that negligence law (economically interpreted) wants defendants to make. *But see supra* text accompanying notes 111-13.

<sup>154</sup> See Mark F. Grady, *Why Are People Negligent? Technology, Nondurable Precautions, and the Medical Malpractice Explosion*, 82 NW. U.L. REV. 293, 306 (1988).

I can invite the reader to clarify his own attitudes towards the preventability of negligence by asking him to consider what his response would be to several hypothetical auto insurance company offers—offers of the precise sort that are suggested by Shavell's First Proof. Offer 1: The insurer will significantly reduce the insurance premium so long as the liability policy excludes accidents caused by the insured's drunk driving. This is an offer which, I suspect, many insureds would find attractive; drunk driving

Let me now bring together the several observations generated by considering Shavell's First Proof. To the extent that a defendant, operating under a standard of either negligence liability or strict liability, can, through an appropriate effort, reduce the incidence of his tortious conduct, it may make sense for him to turn down a liability insurance contract. Even so, for several reasons a willingness to bear reasonable burdens cannot eliminate the risk of liability. One reason is that a rule of strict liability, if applicable, can subject a defendant to a liability exposure that cannot be avoided, even in form, by the incurring of reasonable expenditures; a second reason is that the incurring of expenditures that the defendant deems reasonable cannot prevent the jury from rendering an erroneous or doubtful finding of negligence; a third reason is that there are certain forms of legally negligent conduct that a defendant can realistically control in part but not in whole.<sup>155</sup> Given this combination of

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seems to be the kind of conduct that most of us can control and hence avoid. Offer 2: The premium reduction is tied to an exclusion of accidents caused by the motorist's gross speeding—speeding that is at least 25 mph in excess of the speed limit. This, too, is an offer that I think many motorists would regard as appealing, on account of the apparent controllability of the extreme misbehavior that the exclusion targets. Offer 3: The premium reduction is tied to an exclusion for all accidents caused by speeding. Here I am much less certain that the offer would be widely accepted; ordinary speeding is a negligent activity that many of us think we have an incomplete ability to avoid. Offer 4: The reduction is tied to an exclusion for all accidents caused by the insured's absent-mindedly taking his eyes off the road. Here I am quite certain that most of us would find this offer unacceptable. An absent-minded failure of perception may clearly come within the law's definition of negligence; yet most motorists understand that as a practical matter their ability to prevent such negligence is clearly imperfect, and that insurance therefore provides a very important form of protection.

To be sure, in these hypotheticals the factor of self-selection would obviously be important. Offer 1 would look especially bad to a driver with a drinking problem, especially good to a driver who is a teetotaler. Moreover, liability for speeding may be an imperfect example of pure negligence liability. The tort definition of speeding results from the interaction of statutory speed limits and the common-law doctrine of negligence per se. Yet the speed limits enacted by public authorities may in some instances be well below the limits that the common-law's Learned Hand test would itself authorize.

<sup>155</sup> In short, the demand for flatly priced negligence liability insurance may well reveal the (partial) inaccuracy of the economist's conventional assumption of rational human conduct.

The special quality of "inattentive" negligence has recently been attended to by Professors Shavell and Grady. According to Shavell, "a party may be unable to control completely his momentary level of care." S. SHAVELL, *supra* note 3, at 81. That is, a party can perhaps control his momentary carefulness 95% of the time, but not 100% of the time. Yet courts insist on looking at the negligence question in the context of reasonable conduct in the individual case. Therefore, courts end up disregarding the normal 5% inattention rate. See *id.* Shavell seems uncertain as to whether this disregard is economically intelligent. See *id.* at 82-83.

According to Grady, parties do in fact fully "choose" the "level of advertance" that they will display in their day-to-day conduct. Grady, *supra* note 154, at 306. However, since always paying attention would entail significant costs, a rational actor will "choose to be [inadvertant] some of the time." *Id.* at 295. Yet courts, in making findings of

reasons, there remains a strong demand for liability insurance. This demand relates, in part, to torts that the defendant cannot adequately prevent. Even so, once this insurance is in place, insofar as it is flatly priced there is a moral-hazard likelihood of a reduction in a defendant's safety efforts—a reduction that will tend to increase the level of the defendant's tortious conduct that is clearly preventable.<sup>156</sup>

Worrying about the various facets of moral hazard, an economist such as Thomas Schelling finds it appropriate to conclude that flatly priced liability insurance offends the norm of economic efficiency.<sup>157</sup> This conclusion may, however, be premature. As noted in Part II, if both insurer and insured do agree on an insurance contract, their agreement indicates that the contract enhances the welfare of each. This, however, is a contract that has an external effect on a third party—the person who suffers an injury on account of the effects of moral hazard.<sup>158</sup> At first, this third party seems like a clear

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negligence, deliberately ignore these costs. *Id.* at 302-03. As a result, what is ostensibly a negligence standard ends up including a major measure of "strict liability." *Id.* at 307. Grady seems uncertain as to whether this judicial practice is economically intelligent. *Id.* at 309-10 ("The no-forgetting rule . . . has both advantages and disadvantages . . .").

In any event, Grady is able to render inattentive behavior in compliance with economic norms of rational conduct only by asserting that one's momentary level of attention is fully controlled by one's prior choices. He offers, however, no proof for this assertion, which most of us would regard as counterintuitive. See Schwartz, *supra* note 151, at 718. Shavell, by conceding that parties *cannot* completely control their own conduct, comes close to conceding my point that the phenomenon of inattentive conduct impairs the economist's notion of behavioral rationality. Moreover, as Shavell and Grady enlarge their analyses to take the phenomenon of inattentive conduct into account, they are required to depart from economic conventions in important ways. Each is led to recognize that in many negligence cases the basic economic rationale for the doctrine of negligence liability does not apply—and to acknowledge that in such cases the imposition of liability is, in fact, economically problematic.

<sup>156</sup> Having explained here how uncertainties in the negligence standard help create a demand for completely flat insurance, let me now comment on how this explanation relates to the existing law-and-economics literature on the uncertainty question. In a leading article, Calfee and Craswell contend that uncertainties in the application of the negligence standard in some ways discourage defendants from adopting appropriate precautions, but in other ways encourage defendants to adopt excessive precautions. On balance, they conclude, the tendency towards excessive precautions is likely to predominate. John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965 (1984). By bringing in the insurance factor, my Article identifies an important way—unnoticed by Calfee and Craswell—in which uncertainty induces inadequate precautions, at least to the extent that insurance is flatly priced. Negligence-standard uncertainties encourage defendants who might otherwise go bare to instead purchase flatly priced liability insurance—and once that insurance is in place, moral hazard may induce defendants to adopt a lower level of precautions than negligence law anticipates.

<sup>157</sup> See Thomas C. Schelling, *An Economist Looks at Risk and Liability*, in *RISK, COMPENSATION AND LIABILITY: THE POLICE CHOICES* 53, 64-66 (1986) (proceedings of a conference held at Yale University).

<sup>158</sup> The *Breeden* majority accepted as important precedent previous holdings affirming the legality of fire insurance contracts protecting the insured against the conse-

and dramatic victim of the insurance contract.<sup>159</sup> Notice, however, that this victim, by hypothesis, possesses a tort compensation right against the defendant. In the absence of liability insurance, the victim would have avoided injury altogether. With liability insurance, he suffers injury and the losses associated with injury—but he also is provided with the benefits of tort compensation to cover those losses.<sup>160</sup> So long as tort compensation is sufficiently complete, the package of injury-plus-compensation provides the victim with a satisfactory substitute for the avoidance of injury.

This describes the reasoning that Professor Shavell pursues in reaching his conclusion that even completely flat liability insurance is consistent with the standard of economic efficiency.<sup>161</sup> Call this Shavell's Second Insurance Proof, a Proof that has been acceded to by Posner and Landes.<sup>162</sup> Without doubt, there is real power and

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quences of his own negligence. 220 Mo. at 431, 119 S.W. at 608. The dissent thought such holdings clearly distinguishable, because first-party insurance is "wholly between the parties entering into the contract and affects no other . . . persons except those mentioned in the policy." *Id.* at 359, 119 S.W. at 583-84.

<sup>159</sup> Here I should deviate from the text's economic analysis in order to set forth one fairness point. It might be argued that it is unfair for a defendant to injure the plaintiff by the defendant's improper conduct—and that tort law, by placing sanctions on improper conduct, can contribute to fairness by discouraging people from engaging in that conduct. This argument certainly relates to deterrence; hence it resembles the liability-rule analysis undertaken by economists. Still, the argument refers to deterrence for the sake of fairness rather than deterrence for purposes of efficiency. An efficiency analysis of deterrence is required to acknowledge, as my text here suggests, a significant number of "ifs, ands, and buts" concerning the welfare of the insured and the insurer. These are acknowledgments that might not be required if deterrence were justified by the criterion of fairness. Nevertheless, the welfare that liability insurance produces is closely associated with what might well be deemed the fairness advantages of liability insurance, advantages that any overall fairness evaluation would want to take into account. *See supra* text accompanying note 43. Accordingly, the advocate of deterrence-as-fairness, like the proponent of efficient deterrence, is required to engage in some form of balancing.

<sup>160</sup> The *Breeden* dissent, insofar as it analogized liability insurance to a disclaimer of liability, inadequately appreciated this point. *See* 220 Mo. at 355, 119 S.W. at 582.

<sup>161</sup> *See* S. SHAVELL, *supra* note 3, at 212-13, concluding that this insurance is "socially desirable." Shavell reaches this conclusion by relying on certain assumptions; my text now considers the accuracy of these assumptions in the context of American tort law.

<sup>162</sup> *See* W. LANDES & R. POSNER, *supra* note 3, at 13. To be sure, there is something extremely curious about the Proof. The economic theory of tort law is generally oriented around the goal of optimal deterrence; the compensation received by the plaintiff is viewed primarily as a device to encourage plaintiffs to bring those suits that will achieve deterrence objectives. Suddenly, given Shavell's Second Proof, the economists' priorities seem reversed: the compensation afforded to the tort victim becomes, in a sense, the justification for the elimination of deterrence that is occasioned by a flat insurance policy.

Shavell and Landes & Posner each support Shavell's Second Proof in portions of their books that consider insurance issues. Other passages in their books discuss why the incidence of negligent conduct is as high as it seems to be; and in these passages each book curiously omits any reference to liability insurance. *See* S. SHAVELL, *supra* note 3, at 83-84; W. LANDES & R. POSNER, *supra* note 3, at 72-73. What can, perhaps, be inferred from these omissions is that the authors are somewhat uneasy about the Second

ingenuity in this Proof. It concedes the premise relied on by many tort scholars: that liability insurance can frustrate deterrence. Yet it refutes the conclusion these scholars profess to draw: that this frustration invalidates the economic rationale for tort liability rules.

Even in acknowledging, however, the ingenuity of the Proof, we can observe that the Proof, with its benign conclusion as to the efficiency of insurance, may well rest on an inadequate understanding of how the tort system works. In order to collect what tort law describes as full compensation, the tort victim must ordinarily secure the services of a lawyer, who will reduce by one-third the compensation the victim receives. Because of this transaction cost, even if damage rules were one hundred percent complete the successful plaintiff would nevertheless suffer a net loss of thirty-three percent.<sup>163</sup> In addition, those damage rules obviously fail to achieve completeness. In cases of serious disability or serious pain and suffering, tort law plainly undercompensates, in the sense of awarding a sum of money that no plaintiff would regard as an adequate substitute for the experience he undergoes. If the defendant's tort results in the victim's death, the defendant in a wrongful death action is not required to pay for the value of the life to the victim himself; for that matter, even if life-value were somehow included in wrongful-death damages, the actual victim would obviously be prevented from receiving this portion of the award.

Certain implications of the above observations should here be drawn out. From the vantage point of basic tort deterrence theory, the modest measure of damages in wrongful death actions is seriously inefficient.<sup>164</sup> The impact of these rules on liability insurance essentially serves to make a bad situation worse. That basic deterrence theory, however, does not disapprove in the same way of the legal measure of damages for disability or pain and suffering. For somewhat complicated reasons—relating to the manner in which a serious injury may diminish the utility that a person achieves through the receipt of money<sup>165</sup>—such an award may be quite high

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Proof; while they support it, they still are somewhat embarrassed by the law's willingness to sacrifice deterrence for the sake of insurability.

<sup>163</sup> In assuming that the defendant's liability equals the plaintiff's recovery, see S. SHAVELL, *supra* note 3, at 218, 223, Shavell adopts a model that essentially assumes away the plaintiff's litigation costs. An earlier article of mine adverts to these costs in critiquing the conventional economic rationale for contributory negligence rules. See Schwartz, *supra* note 151, at 711-12.

<sup>164</sup> See W. LANDES & R. POSNER, *supra* note 3, at 187-89.

<sup>165</sup> An award is high enough for deterrence purposes if it could compensate potential victims *ex ante* for their bearing of risk. The problem is that the incurring of serious injury may (among other things) enormously impair a person's ability to derive satisfaction from the receipt of money. See David Friedman, *What is "Fair Compensation" for Death or Injury?*, 2 INT'L. REV. L. & ECON. 81 (1982). Hence any award that fully compensates



enough to satisfy the basics of ex ante deterrence theory even though it clearly does not provide ex post compensation to an individual plaintiff which leaves that plaintiff perceiving that he has been completely compensated for the injury he has incurred. Still, that latter measure of full after-the-fact compensation is what Shavell's Proof requires;<sup>166</sup> the law's unwillingness (or inability) to require such compensation hence impugns that Proof.

In short, enforcement costs and limitations on tort damage rules render most victims "worse off" by converting injury avoidance into the package of injury-and-compensation; indeed, some victims, particularly those of fatal accidents, are disastrously disadvantaged by this conversion.<sup>167</sup> Accordingly, even though liability insurance distinctly benefits insureds, to the extent that it is flatly priced it subjects victims to a significant burden. Now consider a shift from a society (such as the United States in 1850) in which there is no liability insurance to a post-Breeden society (such as ours) in which primarily flat insurance policies exist and are judicially validated. Economic efficiency in the Pareto-superior sense requires that a judicial ruling enhance the welfare of at least one person

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ex post would need to be vastly higher than the award that fully reflects the risk ex ante. Shavell's assumptions, however, ignore this differential.

<sup>166</sup> For reasons relating to the theory of first-party insurance, some economists have recently argued for a sharp reduction in the size of tort awards. See, e.g., P. DANZON, *supra* note 107, at 155-57.

<sup>167</sup> My analysis here follows Breeden:

For if it be conceded that in personal injury cases the injured party or his representatives have been fully compensated from a moneyed standpoint by the person who caused his injury, yet that would not restore the injured party or his family to its *status quo*, for the obvious reason that if he is killed no power on earth can restore the life which had been uselessly sacrificed. . . . And in case the injured person is not killed but seriously injured and crippled, then money could not compensate for the physical pain and mental anguish suffered by him, or compensate him for the joys and pleasures wrongfully taken from him.

220 Mo. at 361, 119 S.W. at 585.

Shavell concedes in a footnote that his analysis affirming the social desirability of liability insurance "obviously changes if victims are not fully compensated for losses." S. SHAVELL, *supra* note 3, at 212 n.9. On two later occasions, however, in restating his conclusion on social desirability, he omits this caveat. *Id.* at 213, 293. The only illustration of incomplete compensation mentioned in his footnote involves the special case of the limited-solvency defendant. As it happens, in a 1982 article Shavell acknowledged that the victim's injury might include a "nonmonetary component"—"perhaps blindness or paralysis"—that cannot be adequately compensated for by money. See Steven Shavell, *On Liability and Insurance*, 13 BELL J. ECON. 120, 128 (1982). This acknowledgment, however, does not get carried forward into his 1987 book.

In endorsing Shavell's favorable assessment of liability insurance, Landes and Posner explicitly assume "that victims indeed are fully compensated." W. LANDES & R. POSNER, *supra* note 3, at 13. They do not indicate; however, the likely inaccuracy of this assumption.

while diminishing the welfare of no one.<sup>168</sup> For the judiciary, as in *Breeden*, to bestow its approval on flat liability insurance appears at first to violate the Pareto-superior standard, since there is a class of persons who are rendered worse off by the existence of that insurance policy. Admittedly, that Pareto-superiority requires a universality of non-losers makes it seem excessively precious as a standard for real-world legal rules.<sup>169</sup> The milder but often more practical Kaldor-Hicks version of economic efficiency requires that all the welfare gains effected by a change in the rules exceed all welfare losses;<sup>170</sup> it is, indeed, the Kaldor-Hicks criterion that scholars rely on in advancing the theory that economic principles can explain most of the common law of torts.<sup>171</sup> Yet a Kaldor-Hicks evaluation of flat insurance seems at first uncertain, since one cannot conclude, in any a priori way, that the welfare gains associated with this insurance do (or do not) outnumber the welfare losses. To set forth this assessment is, of course, to say that flatly priced liability insurance apparently affects the distribution of wealth between injurers and victims, benefitting the former at the expense of the latter.

To be sure, my analysis until now has assumed a world in which injurers and victims form separate classes. This assumption holds up well in many tort settings: for example, suits by innocent bystanders against parties who manufacture defective products or engage in ultrahazardous activities. In other tort settings, however, the assumption may partake of an excessively ex post character. Motoring provides one illustration of an important tort activity in which the individual motorist might wind up as either a tort plaintiff or a tort defendant. Hence that motorist is eventually eligible to receive both the benefits and the detriments associated with liability insurance.<sup>172</sup> Also, many potential plaintiffs are in commercial relationships with potential defendants. Given those relationships, the benefits that insurance provides to the latter may provide some benefits to the former as well;<sup>173</sup> conversely, the burdens borne by po-

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<sup>168</sup> See Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 515-17 (1980).

<sup>169</sup> See Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 489 (1980).

<sup>170</sup> See Coleman, *supra* note 168, at 513-14, 518-20.

<sup>171</sup> See W. LANDES & R. POSNER, *supra* note 3, at 16; see also RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 92 (2d ed. 1983) ("[M]ost economists say Pareto but use Kaldor-Hicks in making welfare judgments.").

<sup>172</sup> Of course, as auto insurance practices reveal, some classes of motorists are much more likely to commit torts in the future than are others. Within tort law, an ex ante identity of victims and injurers is the exception rather than the rule.

<sup>173</sup> On its facts, *Breeden* concerned an employer's tort liability to its employee. According to the *Breeden* majority, the benefit that the employer receives from liability insurance "promotes business . . . and thereby increases the demand for labor and tends to improve wages . . ." 220 Mo. at 430, 119 S.W. at 608.

tential plaintiffs on account of moral hazard can be indirectly experienced by potential defendants.

These circumstances do not affect my previous point that the Kaldor-Hicks efficiency of liability insurance seems *a priori* uncertain. They do complicate, however, the general claims that liability insurance actually fails the Pareto efficiency test and that it affects the distribution of wealth between victims and injurers. While these claims are quite sound in many tort settings, in other settings the *ex ante* reevaluation conducted here suggests that the claims are somewhat premature. Instead, in these settings uncertainty should be recognized as the appropriate Pareto appraisal as well; moreover, the effect of liability insurance on societal wealth distribution can be evaluated as similarly uncertain.

In identifying the weaknesses in Shavell's Second Proof, this Article so far has emphasized indeterminacy as the relevant economic evaluation for flatly priced liability insurance. The positive economic theory of tort law stipulates that all (or nearly all) common law tort doctrines rest on an economic foundation.<sup>174</sup> The uncertain efficiency of flatly priced liability insurance poses something of an embarrassment to that theory; what is more, Shavell's Second Proof provides another example of the tendency of economic analysts to unduly simplify actual legal arrangements in order to reach their conclusions that particular rules are indeed efficient. However, if we are willing to complicate our analysis, we can somewhat strengthen the claim on behalf of the efficiency of flatly priced insurance. Four factors can here be identified, each of which might provide that claim with some support.<sup>175</sup>

The first factor concerns the manner in which flatly priced insurance transmits costs to defendants. Assume a defendant who engages in an activity that is covered by a negligence liability rule and who buys a flatly priced insurance policy. In doing so, the defendant will encounter the average liability cost associated with that activity, as calculated by insurance companies. Accordingly, even though flatly priced insurance may undermine defendant's incentives to adopt precautions in the course of an activity, that insurance nevertheless gives defendants an incentive to take the prospect of liability into account in determining which activities to engage in.<sup>176</sup> The combination of liability-plus-flat-insurance clearly exerts an ef-

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<sup>174</sup> See W. LANDES & R. POSNER, *supra* note 3, at 1, 21-24.

<sup>175</sup> A fifth factor relates to what might be a more realistic evaluation of the deterrence potential of liability rules. See *supra* note 119. Notice, also, that strict liability aims at influencing precautions as well as activity decision; liability-with-flat-insurance can affect only the latter.

<sup>176</sup> Keep in mind that even flat insurance premiums are largely based on a defendant's activity. See *supra* note 21.

fect on the volume of risky activities that would be lacking in a no-liability situation.<sup>177</sup> Moreover, no doubt many parties who buy insurance under statutory mandates have so little wealth that, without insurance, they would be unconcerned about the threat of negligence liability in selecting their precautions. For such parties, the incentives for appropriate activity decisions afforded by liability-plus-compulsory-insurance can be seen as a pure safety gain for which insurance can take credit. As noted above, the control of activity decisions is an objective ordinarily associated with strict liability.<sup>178</sup> In light of that objective, flatly priced insurance can be understood as providing a strict-liability dimension to all of tort liability.<sup>179</sup>

The second factor concerns the added compensation that liability insurance makes possible for victims. Of course, this factor is without relevance for the victim who would never have been injured had it not been for the moral-hazard effects of the defendant's liability insurance policy; nor does it have relevance when the plaintiff's injury is of an amount that is less than the defendant's assets. Still, on account of strict liability and the partial uncontrollability of negligent conduct, many torts would be committed even if defendants were uninsured; moreover, as noted above,<sup>180</sup> in many of the suits occasioned by these torts, the tort judgment will exceed the defendant's wealth. In these cases, the compensation payment received by the victim is enlarged by (up to) the amount of the defendant's liability insurance policy.<sup>181</sup> Though the compensation of accident victims is not an actual *objective* of tort law under an economic analysis,<sup>182</sup> the added compensation that liability insurance provides is a gain for (some) victims that Kaldor-Hicks economics certainly should take into account in considering whether all the gains associated with liability insurance exceed all the losses.<sup>183</sup> Moreover, this

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<sup>177</sup> See, e.g., Richard W. Grayston, *Deterrence in Automobile Liability Insurance—The Empirical Evidence*, 40 INS. COUNS. J. 117 (1973) (higher liability insurance premiums reduce the incidence of motoring, and hence of negligent motoring).

<sup>178</sup> See *supra* notes 111-13 and accompanying text.

<sup>179</sup> Observe, however, that such insurance implements that objective in a manner that is quite distinct from its implementation under uninsured strict liability. A strict liability regime imposes liability on defendants for all accidents caused; negligence-with-flat-insurance imposes liability on insureds only for accidents negligently caused. Relatedly, there is a litigation-cost differential between strict liability and negligence liability.

<sup>180</sup> See *supra* text accompanying notes 68-69.

<sup>181</sup> A defendant's motives for buying this insurance are assessed *infra* text accompanying note 69.

<sup>182</sup> See Coleman, *supra* note 75, at 1323.

<sup>183</sup> Shavell refers to this point, but in a manner that tends to limit its significance in assessing the efficiency of insurance. See S. SHAVELL, *supra* note 3, at 213 n.12, 242-43.

The victim who is risk-averse is likely to have protected himself in advance by a first-party insurance policy. To this extent, the victim's claim against the defendant may be

is one gain attributable to liability insurance that cuts against the idea that this insurance redistributes wealth away from victims.

The third factor bearing on the Kaldor-Hicks efficiency of flatly priced insurance concerns the extent of the benefits that this insurance bestows on insureds. Insurance is most likely to be flatly priced if the insured's activities give rise to only a limited number of claims: when this number is low, insurance techniques such as experience rating and schedule rating are not feasible. Yet consider how a low number of claims affects the benefits associated with insurance. If only an occasional suit is brought against the party, his lack of experience will make it especially difficult for him (if he is uninsured) to assure that his lawyer's performance is effective and loyal. Also, the lower the number of risky episodes in which he engages, ironically the more pure risk he faces, for the less able he is to pool or average out risks within his own operations.<sup>184</sup> In all, then, the circumstances that give rise to flatly priced insurance may well tend to enhance the benefits that insurance brings about.

The fourth factor concerns the loss control services that liability insurers might be able to provide their insureds—services that could generate a safety gain that could offset the safety loss associated with moral hazard.<sup>185</sup> A liability insurer, by processing a large number of claims and by conducting the reviews and inspections that lead to its own underwriting decisions, may well become an expert in techniques of risk prevention—indeed, more of an expert than the insured itself. If so, then this is an expertise that the insurer can pass on to the insured. Of course, the insured, if it thinks it could benefit from safety recommendations, has the option of entering into a contract with an outside safety consultant. Yet transaction costs are reduced if the insured relies on that insurer for its safety information rather than arranging a contract with an outside consultant, for the insured already stands in a contractual relationship with its liability insurer. In addition, the insurer acquires its information in a natural low-cost way, as an incident to its normal activities of underwriting and claims evaluation.

One somewhat tricky question concerns the safety-services in-

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transferred to the first-party insurer, by way of subrogation or a reimbursement right. Such a transfer benefits victims in the medium-run by reducing the cost of first-party insurance.

<sup>184</sup> See *supra* note 15.

<sup>185</sup> This point was relied on by the *Breeden* majority: "[T]he employee, shipper, or passenger . . . has the *added security* of the vigilance, experience and self-interest of the insurance company itself to prevent the use of negligent methods . . ." 220 Mo. at 430, 119 S.W. at 608 (emphasis in original). See also 3 FOWLER V. HARPER, FLEMING JAMES, JR. & OSCAR S. GRAY, *THE LAW OF TORTS* 148-55 (2d ed. 1986) (discussing insurer safety efforts).

centives of the parties. When operating under perfectly responsive insurance, the incentive of the insured to accept the insurer's recommendations is obvious; any reductions the insured achieves in the risks that it creates immediately translate into corresponding reductions in the premium it is contractually obliged to pay. However, the incentive of the insurer to offer these recommendations is problematic, since any reduction in its eventual payouts is offset by a reduction in its premium income. Under completely flat insurance, the incentive analysis is reversed: the insurer now has a keen interest in offering safety recommendations, since its ultimate liability is directly at stake; but the incentives of the insured to accept those recommendations are unclear, since its premium remains constant even if it implements the insurer's presumably costly safety recommendations.

To be sure, even at these two insurance extremes one can identify certain non-trivial elements of mutuality in loss-control incentives.<sup>186</sup> A further point is that in the real world almost all liability insurance policies lie in the intermediate range between perfect responsiveness and complete flatness. Unlike insurance at either extreme—for which the safety incentives seem primarily unilateral—intermediate insurance of this sort does bestow on the insurer and the insured substantial bilateral incentives to cooperate in loss-control efforts.<sup>187</sup> Of course, the extent to which the incentives afforded by intermediate insurance actually translate into successful loss-control activities is ultimately an empirical question. From what one can tell, for example, liability insurers pay little attention to homeowners and motorists, at least partly because these are small accounts that do not “merit individualized attention.”<sup>188</sup> In addition, many product manufacturers report that they receive little

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<sup>186</sup> Under perfectly responsive insurance, prospective insureds have a keen interest in the quality of the insurer's loss-control services; hence the pressures of the marketplace at the time insurance contracts are entered into help to explain why insurers would offer those services. And even when insurance appears to be completely flat, many insureds will have significant *first-party* incentives for accepting insurers' safety recommendations, in order to prevent harm-producing incidents. For example, an assembly-line accident that injures a worker can also damage the employer's valuable equipment and result in costly down time; the manufacturer whose products acquire a reputation for danger may well suffer a significant reduction in sales. Moreover, consider the insured who rejects what the insurer regards as a reasonable safety recommendation; that insured may be able to anticipate that the insurer will later be unwilling to offer the insured a renewal of its policy. Of course, the sanction of nonrenewal is one form of insurance responsiveness that demonstrates the unreality of the completely flat insurance norm.

<sup>187</sup> This is one instance in which this Article's ideal-type strategy breaks down.

<sup>188</sup> See Sugarman, *supra* note 2, at 581. Examples commonly given of extensive loss-control efforts by insurers—for example, boiler inspections by boiler insurers—tend to concern first-party insurance rather than liability insurance.

assistance from their liability insurers.<sup>189</sup> On the other hand, insurers are very active in providing safety services to many employers subject to workers' compensation. Also, as part of the tort liability insurance relationship between Transamerica and the 1984 Los Angeles Olympic Organizing Committee, Transamerica developed a fifteen-hour training program for all LAOOC drivers, and the LAOOC accepted Transamerica's recommendation that the LAOOC undertake full screening (including police checks) of all its personnel.<sup>190</sup>

In sum, a full economic review of primarily flat liability insurance needs to take a number of factors into account;<sup>191</sup> in addition, it needs to measure these factors in an empirical way. However, data that would actually permit quantification of these factors are currently unavailable, and are likely to remain unavailable in the reasonable future. To this extent the overall efficiency of flatly priced insurance remains in a significant sense indeterminate.<sup>192</sup> If I were encouraged to rely on intuition in order to reach some result, my best guess would be that it is probable that this insurance is usually efficient. But I would expand on this guess by noting that the magnitude of the relevant factors almost certainly varies from one "line" of insurance to another; accordingly, even if many lines of primarily flat insurance are indeed efficient, there probably are other lines that flunk the economic test.

A review of the impact of flatly priced liability insurance on the tort objective of deterrence hence produces somewhat complex evaluations. When the impact of liability insurance on tort law's

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<sup>189</sup> See J. O'CONNELL, *supra* note 152, at 24. A much more optimistic impression, however, is conveyed by AMERICAN INSURANCE ASS'N, *PRODUCT LIABILITY INSURANCE: UNDERWRITING, RATES, RESERVES, BUSINESS CYCLES* (1979), discussing, for example, insurance company efforts to "modify the risk." *Id.* at 22.

<sup>190</sup> Bruce Keppel, *Insuring for the Games an Olympic-Size Task*, L.A. Times, April 16, 1984, at IV-2, col. 6. The insurance policy contained "an extraordinarily high limit" of coverage. *Id.* at col. 5.

<sup>191</sup> To recap, these factors include the beneficial deterrent effect of flatly priced insurance on insureds' decisions to engage in risky activities; the welfare gains that liability insurance entails for insureds (and insurers); the safety losses occasioned by the moral hazard effects of flatly priced liability insurance; the extent to which those losses are offset by loss-control services offered by insurers; as for those persons who incur injuries on account of insurance-induced moral hazard, the extent to which tort awards do not adequately compensate them ex post for their losses; and as for those persons who would have incurred injuries even in the absence of liability insurance, the extent to which that insurance adds to the compensation that they end up receiving.

<sup>192</sup> I have no interest in affiliating myself with the extreme position that law-and-economics is pervasively indeterminate. See, e.g., Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387 (1981). Even so, in this and in previous articles I do assert that there is a greater measure of indeterminacy in the economics of tort law than its leading practitioners usually are willing to recognize. See, e.g., Schwartz, *supra* note 151, at 704-10; *supra* notes 144-45 and accompanying text.

possible fairness objectives was considered in Section II, the resulting evaluations were complex in a somewhat different way. Are there further objectives attributable to tort law to which liability insurance might relate? This is the question addressed in Section V.

## V

## LIABILITY INSURANCE, VICTIM COMPENSATION, AND LOSS SPREADING

This Article already has considered, in two separate contexts, the relevance of the compensation afforded the accident victim. When liability insurance is analyzed from an economic perspective, the extra compensation that it yields to the victim is a benefit to be taken into account in determining whether liability insurance survives a Kaldor-Hicks review. Secondly, if the defendant's tort causes an accident, then principles of compensatory or corrective justice may require that the plaintiff receive compensation (a requirement that liability insurance helps satisfy). When, for example, a court states that all victims of negligence should be granted compensation,<sup>193</sup> it is evidently the principle of compensatory justice that the court has in mind.

Sometimes, however, tort law is more broadly associated with the objective of cushioning the burden borne by all victims of injury (or, by all "deserving" victims).<sup>194</sup> At stake here is not any notion of interpersonal fairness but rather a more general and supposedly compassionate social policy in favor of victim compensation.<sup>195</sup> To be sure, such a social policy, when vindicated simply by allowing the plaintiff to recover in tort against the defendant, seems inane, for that tort recovery merely shifts a devastating loss from the plaintiff to the defendant, leaving the defendant as miserably burdened by the tort judgment as the plaintiff was burdened by the original accident.<sup>196</sup> The social policy of victim compensation begins to make sense, however, if the tort defendant is a suitable loss-bearer. The defendant may have loss-bearing abilities for a number of reasons.<sup>197</sup> First, the defendant might be a wealthy entity with deep-

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<sup>193</sup> "It is, of course, fundamental in the law of torts that any person proximately injured by the act of another, whether that act be willful or negligent, should, in the absence of statute or compelling reasons of public policy, be compensated." *Klein v. Klein*, 58 Cal. 2d 692, 694, 376 P.2d 70, 71, 26 Cal. Rptr. 102, 104 (1962).

<sup>194</sup> See John G. Fleming, *Is There a Future for Tort?*, 44 L.A. L. REV. 1193, 1203 (1984); Williams, *supra* note 4, at 151-152.

<sup>195</sup> To be sure, victims can alternatively be reimbursed by way of first-party insurance. The loss-spreading rationale for tort law typically assumes (at least implicitly) some major inadequacy in the market for first-party insurance.

<sup>196</sup> Consider the facts in *Brown v. Kendall*, 60 Mass. (6 Cush.) 292 (1850).

<sup>197</sup> See G. CALABRESI, *supra* note 4, at 39-67.



pocket attributes. Second, the defendant may be a commercial organization that can respond to liability in a loss-spreading way by marginally raising the prices that it charges to large numbers of its customers. Third, the defendant, so long as he is minimally solvent, can effectively spread the loss through the purchase of liability insurance.

Given the importance of this third possibility, those who see victim compensation as a major tort objective will obviously regard liability insurance as fully acceptable. Indeed, it is an integral part of the policy argument; liability insurance is the institution that permits tort law to achieve this policy in a large number of situations in which the policy might otherwise be incapable of implementation. The victim compensation goal suggests that liability insurance is highly desirable regardless of whether it is responsively or flatly priced; indeed, it may be that liability insurance should be compulsory, so that the tort-insurance system can do a more effective job of delivering compensation to needy victims.

Liability insurance is hence an essential part of tort law *if* victim compensation is assumed to be the law's purpose. In some sense liability insurance obviously has the *effect* or *consequence* of spreading losses in some number of cases; how plausible, however, is the idea that loss spreading is the law's actual *objective*? This question can be approached in two ways. One approach relates to the purpose of the judiciary. Many tort scholars, including Professors Priest<sup>198</sup> and Sugarman,<sup>199</sup> believe that the expansion of tort liability rules over the last thirty years has in fact been substantially due to a judicial desire to extend the benefits of loss spreading to larger and larger circles of accident victims.<sup>200</sup> Their position is supported, moreover, by the rhetoric in certain judicial opinions, mostly in the products liability area.<sup>201</sup> Other scholars, however, adhere to the view that loss-spreading considerations have played no more than a mi-

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<sup>198</sup> See Priest, *supra* note 37, at 1534-36.

<sup>199</sup> See Sugarman, *supra* note 2, at 591; see also Fleming, *supra* note 194, at 1195.

<sup>200</sup> A more limited claim would be that juries (and judges), in applying ordinary rules of tort liability, have resolved doubts liberally in favor of victims so as to take advantage of the loss-spreading potential of defendants' insurance policies. A more general claim concerns the purpose of state legislatures in enacting a variety of liability insurance requirements. For example, victim compensation may well be the purpose of the legislature in requiring the purchase of auto liability insurance. There are, however, other possible explanations for compulsory auto insurance. See *supra* note 68 and accompanying text.

<sup>201</sup> See, e.g., *Escola v. Coca-Cola Bottling Co.*, 24 Cal. 2d 453, 462, 150 P.2d 436, 441 (1944) (Traynor, J., concurring) ("The cost of an injury . . . may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business.").

nor role in recent tort developments.<sup>202</sup> They are inclined to downplay the judicial rhetoric as surplusage or window-dressing,<sup>203</sup> or at the least to conclude that the rhetoric is limited to products liability.

This disagreement in assessing judicial purpose is one that I will agnostically make no effort to resolve here. A second line of inquiry concerns the suitability of tort law for fulfilling whatever social policy there may be on behalf of victim compensation. On this point, a considerable number of scholars—including, but by no means limited to, Priest<sup>204</sup> and Sugarman<sup>205</sup>—have identified fundamental features of the tort regime that make almost no sense if loss spreading is accepted as the relevant tort norm.<sup>206</sup> First of all, even when tort law's liability rules are liberally defined, those rules reach only a limited number of accident victims, hence leaving uncompensated large numbers of victims whose losses could quite usefully be spread.<sup>207</sup> Furthermore, those victims whose claims tort law *does* affirm receive a measure of compensation that for loss-spreading purposes seems clearly excessive; the loss-spreading concept, for example, does not justify large awards for pain and suffering, nor does it condone the double compensation that is called for by tort law's collateral source rule.<sup>208</sup> Moreover, the doctrines that tort law recognizes for purposes of defining eligibility for compensation, such as negligence and proximate cause, are so expensive to administer as to render tort law quite awkward as a device for delivering compensation. In addition, the need to apply those doctrines on a case-by-case basis inhibits the prompt disposition of tort claims, which means that tort compensation is subject to delays that a victim compensation program should not tolerate. Finally, if tort law is conceived of as something like a compensation program, then the regressivity entailed in its distribution of wage-loss awards seems objectionable.

The obvious strength of these criticisms makes it somewhat dif-

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<sup>202</sup> See, e.g., Henderson, *supra* note 1, at 788-92 (suggesting that "fairness" and "utility" are the actual goals of tort law, and that tort law has never professed to be concerned with, or attempted to solve, the general problem of victim compensation).

<sup>203</sup> See Schwartz, *supra* note 40, at 769 (discussing Prosser's views).

<sup>204</sup> See Priest, *supra* note 37, at 1550-60.

<sup>205</sup> See Sugarman, *supra* note 2, at 592-96. See also Atiyah, *supra* note 2, at 280-90; Fleming, *supra* note 194, at 1203-07.

<sup>206</sup> Workers' compensation programs are designed to exclude the tort features that are described in the text. Those programs are therefore able intelligently to pursue their undeniable goal of loss spreading.

<sup>207</sup> A related point is that the loss-spreading rationale for tort law tends to ignore the extent to which accident losses are already reimbursed by a variety of non-tort sources. Data on this point are currently being gathered by the Rand Corporation Institute for Civil Justice.

<sup>208</sup> Also, compensation program policy strongly suggests reimbursement even for economic losses at something less than an 100% rate.

ficult for me to adhere to my preferred position of open-mindedness as to tort law's proper goals. Even so, this position can retain adequate viability by noting several factors. First of all, there remain at least a few scholars who clearly approve of the idea of tort law pursuing the loss-spreading goal.<sup>209</sup> Second, the criticisms in question can possibly be deflected by conceding that loss spreading should not be tort law's *primary* objective but simply one valid objective among many that tort law ought to pursue.<sup>210</sup> Third, it is noteworthy that scholars such as Sugarman and Priest oppose a loss-spreading function for tort law in significant part because they believe that loss spreading can be better achieved through alternative strategies: Sugarman, as a liberal, recommends expanded social insurance programs,<sup>211</sup> while Priest, as a conservative, recommends increased reliance on private first-party insurance.<sup>212</sup> It is, however, highly unlikely that current legislatures will implement Sugarman's proposals; and Priest's recommendation ignores the serious problems of adverse selection and moral hazard that inevitably depress the private market for disability insurance.<sup>213</sup> For our purposes here, the relevant point is that once the impracticability of alternative loss-spreading techniques is acknowledged, the analyst might become somewhat more charitable in reviewing the loss-spreading function or capacity of tort law.

In any event, what can be said, on balance, is that *if* judges have relied on the social policy of loss spreading in expanding tort liability rules—which is a clear possibility—then liability insurance is an essential part of the overall judicial enterprise. If, however, it is also correct that tort law is ill-equipped to achieve that policy, then liability insurance is an institution that may have enticed the judiciary into making an unfortunate mistake.

### CONCLUSION

Though in the modern world many tort defendants are self-insured, many other defendants seek the coverage of liability insur-

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<sup>209</sup> See, e.g., Virginia E. Nolan & Edmund Ursin, *The Revitalization of Hazardous Activity Strict Liability*, 65 N.C.L. REV. 257, 286-93 (1987); see also 3 F. HARPER, F. JAMES, & O. GRAY, *supra* note 185, at 149 (loss spreading should be a primary tort objective). Scholars such as Nolan, Ursin, and Gray have yet to respond, however, to the criticisms summarized here.

<sup>210</sup> Consider Calabresi's recommendation that "accident law" pursue a variety of goals, including loss spreading. See G. CALABRESI, *supra* note 4, at 24-33. It is noteworthy, however, that in Calabresi's view the tort system fails dismally when measured in these mixed terms. *Id.* at 239-308.

<sup>211</sup> See Sugarman, *supra* note 2, at 648-51.

<sup>212</sup> See Priest, *supra* note 37, at 1588-90.

<sup>213</sup> See Kenneth S. Abraham, *Disability Insurance and Tort Reform* (1987 unpublished manuscript).

ance. This insurance provides an insured with valuable benefits, in terms of the protection it affords against a variety of risks: the risk that his tortious conduct will materialize in an injury; the risk that the resulting injury will be severe; and the risk that the uncertainties of the tort system will subject him to unjustified liability (or at least unjustified defense costs). Ethical and economic criteria each assign a high ranking to these insurance-related benefits.

Yet a due appreciation of these benefits cannot rule out the possibility that liability insurance is in conflict with the tort law's actual objectives. Should there be such a conflict, then *either* liability insurance *or* the tort system should be abandoned or modified. Most liability insurance is written so as to render its premium somewhat responsive to the level of tortious risktaking engaged in by the insured. Nevertheless, it is useful to analyze insurance at the extremes of perfect responsiveness and complete flatness. Flatly priced insurance is inconsistent with the goal of retributive justice; however, perfectly responsive insurance enhances the law's ability to achieve that goal. Liability insurance, regardless of its form, is highly desirable if compensatory justice is tort law's objective. The goal of corrective justice, as elaborated by scholars such as Fletcher, approves of responsive liability insurance but is hostile to liability insurance to the extent that it is flatly priced. The goal of corrective justice, as stated more forcefully by a scholar such as Weinrib, seems antagonistic to *all* forms of liability insurance. However, moderately responsive liability insurance satisfies a tort theory that relies on a combination of compensatory justice and a moderate measure of corrective justice.

In some number of cases, liability insurance certainly has the effect of spreading losses. To the (uncertain) extent to which judges regard loss spreading as an important tort objective, liability insurance performs an essential function. Insofar as it is responsively priced, liability insurance poses no problem for economically-based deterrence theories of tort law. Flatly priced liability insurance, however, raises a real moral-hazard problem: once defendants are covered by such insurance, they might no longer avoid tortious conduct. Taking the prospect of moral hazard into account, Shavell's First Proof predicts that potential defendants, operating under a negligence liability rule, will decline to buy such insurance. The real-world inaccuracy of this prediction underscores, in part, how very serious and very expensive are the problems caused by the uncertainties surrounding the negligence standard. In addition, that prediction's inaccuracy strongly suggests the (partial) error in the economists' assumption of rational conduct—the assumption that

gives rise to the economists' conventional justification of the negligence liability rule.

Shavell's Second Proof, which claims that even flatly priced liability insurance is economically efficient, is spoiled by the extent to which tort damage awards do not, *ex post*, provide victims with full net compensation for the injuries they have suffered. In truth, the efficiency of such liability insurance is an uncertain question. Factors that make it somewhat more likely that this insurance is on balance efficient include the possibly favorable effect of insurance on actors' decisions to engage in liability-producing activities, the extra compensation that insurance affords to victims, and the safety value of the loss-control services that insurers might provide.

In general, so long as our tort system tolerates (and at times requires) liability insurance, it is unsound to discuss *any* objective that might be imputed to that system without considering both the incidence of liability insurance and the relationship of that objective to liability insurance in its various forms. Liability insurance actually promotes certain possible objectives and is at least consistent with some others. This insurance, however, is incompatible with further objectives, especially to the extent that it is flatly priced; and there are additional objectives that it renders problematic.

This Article has adopted an open-minded attitude as to the proper goals of tort law in order to expand its coverage by enabling it to consider how liability insurance relates to a variety of goals that individual scholars may themselves prefer. I should not end the Article, however, without giving the reader some sense of what my *own* judgments are as to proper tort objectives (and accordingly, as to the role of liability insurance). I will make no effort here to defend these judgments, except to point out that the Article's previous discussions of individual objectives include material that gives the reader some idea as to where my judgments come from. In my view, it is inappropriate to invoke either retributive justice or loss spreading as justifications for tort law as we know it. For my purposes, deterrence is clearly an important tort goal; but here I fall within the camp of those who believe that tort law, even without insurance, can be moderately successful—but no more than this—in achieving deterrence.<sup>214</sup> Given this assessment, and given, as well, the likelihood of moderately responsive forms of insurance, I am willing to estimate that most liability insurance policies are efficient. To be sure, this is only an estimate, and even it concedes the possibility that insurance is frequently inefficient. Still, this is no more than a possibility; accordingly, while economics falls short of providing a

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<sup>214</sup> See *supra* note 119.

solid general argument in favor of liability insurance, it does not, in my view, afford any reason for generally opposing that insurance.

In the meantime, liability insurance seems distinctly fair in the way it enables parties to protect themselves from the tort system's various risks—including the distressing risks of defending against false claims and being subjected to mistaken verdicts. Moreover, compensatory justice is an objective that I regard as appealing; and this is an objective that insurance not only complies with but actively promotes.<sup>215</sup> On balance, then, while I support both economic and ethical approaches to tort law, and while economics clearly plays an essential role in identifying the attributes and implications of liability insurance, I nevertheless find that it is one version of the ethical approach that is best able to provide liability insurance with a clear and unequivocal justification. Alternatively stated, our tort system's commitment to the legality of liability insurance makes me even more willing to believe that principles of compensatory justice do provide a major part of the rationale for that system's liability rules.

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<sup>215</sup> What corrective justice adds to compensatory justice is to my mind helpful but not indispensable; accordingly, somewhat like Professor Smith, I am willing to accept whatever degree of corrective justice can be provided by moderately responsive insurance arrangements.